



RESEARCH REPORT

An Early Assessment of Opportunity Zones for Equitable Development Projects

Nine Observations on the Use of the Incentive to Date

Brett Theodos
URBAN INSTITUTE

Eric Hangen
I-SQUARED

Jorge González
URBAN INSTITUTE

Brady Meixell
URBAN INSTITUTE

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Contents

Acknowledgments	iv
Executive Summary	v
Errata	viii
An Early Assessment of Opportunity Zones for Equitable Development Projects	1
Nine Observations on the OZ Program’s Deployment	5
1. OZs Are Reaching Actors That Had Not Been Engaging with the Community Development Field	5
2. OZs Are Catalyzing an Ecosystem of Community Development Efforts	8
3. The OZ Structure Lacks Encouragement for Resident or Intermediary Engagement	11
4. Many Mission-Based Project Sponsors Are Struggling to Find OZ Investors	14
5. OZ Investors Demand Higher Returns Than Impact Projects Can Provide	19
6. OZs Were Designed to Spur Job Creation, but Most of Their Capital Is Flowing into Real Estate	22
7. Even for Real Estate, Exit Strategies at Year 10 Raise Challenges for Project Sponsors	25
8. To Drive Impact, OZs Often Need to Be Paired with Other Subsidy Sources	26
9. The Need for OZ Financing in OZ Projects Is Mixed	28
Implications and Recommendations	31
Mission Actor Opportunity Zone Use Strategies	32
Broader Changes	34
Appendix. Opportunity Zones Overview	37
Notes	38
References	41
About the Authors	42
Statement of Independence	43

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The Urban Institute's Collaboration with JPMorgan Chase

The Urban Institute is collaborating with JPMorgan Chase over five years to inform and assess JPMorgan Chase's philanthropic investments in key initiatives. One of these is Partnerships for Raising Opportunity in Neighborhoods (PRO Neighborhoods), a \$125 million, five-year initiative to provide communities with capital and tools to develop locally driven solutions to the challenges facing underinvested neighborhoods and the families who live there. In service of these goals, this report reviews and assesses how Opportunity Zones have been deployed across the United States in mission-oriented projects, now that more than two years have passed since the legislation went into effect

Executive Summary

In the two years since Opportunity Zones (OZs) were signed into law, OZ investment had reached at least \$10 billion—and likely more than that—before the COVID-19 crisis took hold. Despite being viewed primarily as an *economic development* tool in low-income communities—that is, positioning the local economy on a higher growth trajectory—many proponents have suggested that OZs also have a *community development* purpose of helping people in poverty to improve their local context and lead healthy, productive lives. We refer to development that blends economic development and community development goals, and that seeks to engage residents and local leaders in decisionmaking about development in their communities, as *equitable development*. This report examines how actors driven primarily by a community development mission have sought to use OZs to fulfill an equitable development mission.

Our research process included about 70 in-depth interviews with project sponsors; fund managers; investors; wealth managers; developers; philanthropies; and public and nonprofit agencies working with OZs, such as community development intermediaries, state OZ program offices, and city-level OZ coordinators. We asked interviewees to describe projects that were funded as well as those seeking funding, the terms of investment sought by project sponsors as well as investors, the nature of community engagement that they have observed, and other opportunities and challenges they perceive around using the incentive for equitable development. We found our sample of OZ projects through discussions with national and local OZ experts, the Opportunity Exchange listing of projects,¹ the Economic Innovation Group's Opportunity Zones Activity Map,² scans of news articles, examples highlighted at a number of convenings around the country (including in Atlantic City, Chicago, Cleveland, Columbia, Greenville, Miami, Norfolk, Salt Lake City, Seattle, and Washington, DC), and through a snowball sample of additional informants we became aware of.

We find that OZs are helping spur the evolution of a new community development ecosystem, engaging both project developers and investors who have limited historical engagement in community development work. Despite this catalytic effect, however, we also see that many mission-oriented actors are struggling to access capital. Many project sponsors are struggling to access the class of investors—wealthy individuals and corporations with capital gains—for whom the OZ incentives are tailored. Additionally, many mission-oriented projects yield below-market returns that most OZ investors appear unwilling to accept. As OZ incentives are not structured to encourage resident or community engagement, mission-oriented projects struggle to compete for attention with higher-return projects—for which OZs provide much larger subsidies because of the design of the incentives.

A further challenge for mission-oriented projects is that the sponsors are seeking to support a community asset with a lifetime well beyond the 10-year time horizon of the OZ incentives. Given that an illiquid investment over a 10-year horizon is already challenging for OZ investors, the type of investment many mission actors need and the OZ market's investment parameters are mismatched. Because of these challenges, we mostly saw mission-oriented projects succeed in using OZs when the capital stack also layered in significant other subsidy sources, or when a well-connected project sponsor was able to locate an investor willing to accept significantly below-market returns.

Although OZs were designed to spur job creation, the vast majority of OZ capital appears to be flowing into real estate, not into operating businesses, because of various program design constraints and the undesirability of selling equity from both the business owners' and the investors' perspective. Ultimately, most developers and investors view OZ incentives as providing a relatively small boost to overall returns. The OZ incentives have had mixed effects in terms of making projects work that would not otherwise happen. Some developers reported that the incentives did make a decisive difference in allowing a project to go forward, while others were clear that their project would have proceeded with or without OZ equity. Most observers appear to agree that a primary benefit of the program is that it elevates the visibility of neighborhoods and deals that investors might not have considered otherwise.

Taken together, these results raise a question for policymakers to reflect on the goals of OZs. To the extent that the OZ incentives were intended to foster equitable development outcomes—such as by creating quality jobs, affordable housing, community-oriented amenities like grocery stores, and improved quality of life for low-income people—our evidence suggests they need to be redesigned to more effectively allocate government dollars to help project sponsors achieve those outcomes. As they redesign OZ incentives, policymakers should use four broad principles to guide the process:

- **Better support investment in small businesses.** The most egregious failing of OZs to date is that very little OZ investment is going to small businesses, the exact group of investees that proponents had held out as standing the most to benefit. To correct this failing, one important solution is incentivizing investments in QOFs that could provide subordinated debt investment, or hybrid debt/equity products such as royalty debt, to small businesses. Beyond that, policymakers should consider granting greater flexibility around certain program rules, such as deployment rules, to mission-driven funds that specialize in small business investing.
- **Size the incentive based on the impact.** Rather than providing the largest incentives to the most profitable projects regardless of their social impact, the incentive should instead depend on project impacts. In turn, by targeting incentives toward investments with the greatest

impacts, these investments could be more deeply subsidized while more efficiently using total federal tax expenditures. To provide one example, OZ tax incentives could be based on the number of quality jobs created by the OZ investment. Other alternatives could include tweaking the incentives based on the equitable development characteristics present in a project, or limiting the incentives only to those types of projects where a positive social impact is deemed likely.

- **Broaden who can invest.** Because only a limited number of (mostly wealthy) taxpayers have capital gains, limiting OZ incentives to capital gains holders freezes out most stakeholders in low-income communities from investing in their own revitalization. A refundable tax credit, rather than a capital gains exclusion, could open up opportunities for these investors. Moreover, other actors such as foundation endowments and pension funds, have substantial resources, and most likely a greater proclivity to consider community investing than many capital gains holders, if an incentive can be structured to engage them.
- **Support mission-driven funds that are accountable to the community.** A redesigned OZ incentive should encourage equity investments in groups such as community development financial institutions (CDFIs), which have a long track record of making substantial investments in low-income communities, taking on higher risks than conventional investors, and working with the kind of investees who have been struggling to access OZ capital, such as small businesses and less sophisticated developers.

Protests in the wake of George Floyd’s killing underscore, among other things, the realities that opportunity is not spread evenly in our nation, especially by race. The COVID-19 health crisis, and the economic recession it is causing, add significantly to the list of challenges for practitioners looking to use the OZ incentive. Investment in operating small businesses are facing particular strain, but consequences will radiate to the financial sustainability of real estate, both commercial—which relies on rents from shuttered businesses—and housing—which relies on rents from residents who may have lost jobs or face a cutback in hours. At the same time, the crisis may provide an opportunity to rethink and redesign the OZ incentive so it can play a stronger role in helping hard-hit communities recover.

Errata

This report was revised July 28, 2020. The image on page 30 came from GMA Construction Group. An earlier version omitted this credit.

An Early Assessment of Opportunity Zones for Equitable Development Projects

Opportunity Zones (OZs) are gaining momentum, and now that the rules regulating them are clearer, investors, local officials, developers, and businesses have been engaging with the incentive. In the two years since the Tax Cut and Jobs Act of 2017 created the incentive and Treasury-designated Zones, hundreds of Qualified Opportunity Funds (QOFs) have been created, and OZ investment was beginning to flow until the COVID-19 crisis began. But has this capital been reaching projects that benefit low- and moderate-income households and communities? Although the program is still maturing,³ and the COVID-19 crisis now poses new challenges whose resolution is unknown, this report offers an early, qualitative assessment of how well OZs have channeled capital into projects aligned with equitable development goals.

The full extent of investment in Opportunity Zones over the past two years is unknown. With no federal requirement for detailed reporting of OZ investments, there is no public record to accurately sum the capital expended, no accounting of which communities have received OZ capital, and no comprehensive documentation of the types of projects funded. News stories, industry reports, and survey data pointed to a significant and growing uptake before the COVID-19 pandemic. Novogradac has tracked data on 621 QOFs, of which 406 have raised equity. Total investment in these documented funds reached \$10.1 billion in April 2020, but this information is self-reported and incomplete.⁴

The Internal Revenue Service (IRS) has deemed OZs primarily an *economic development* tool for low-income communities⁵—that is, they position the local economy on a higher growth trajectory (Feldman et al. 2014). But many proponents have suggested that OZs can also drive *community development*⁶—that is, help people in poverty improve their situation and lead healthy, productive lives (Andrews et al. 2012). By providing a path for community developers to tap into a new pool of investors, OZs could deliver a range of positive social outcomes, including equitable development.

BOX 1

Defining Equitable Development

We define equitable development as a form of neighborhood or community revitalization work that emphasizes outcomes both for people and place. It seeks to improve quality of life for original residents, not simply to transform a community by changing who lives there. It considers local and regional context along with disparities among residents. In this sense, equitable development could be considered the intersection or union of economic development and community development (von Hoffman 2019). In terms of process, it puts residents and local leaders in roles of informing and deciding on which investments should be made and how. There is a larger debate as to whether achieving impact requires deep project subsidies, or, for example, whether purely profit-seeking projects can advance equitable development objectives.^a We cannot resolve that debate here, but we offer that the answer likely depends on local context, though we anticipate that in most cases, deep, structural, and long-standing inequities across geographies and people groups cannot be resolved solely by investors seeking market-rate returns and accepting conventional risks.

^a For example, see Kevin Starr, “The Trouble with Impact Investing: P1,” *Stanford Social Innovation Review*, January 24, 2012, https://ssir.org/articles/entry/the_trouble_with_impact_investing_part_1; and Matt Bannick and Paula Goldman, “Do No Harm: Subsidies and Impact Investing,” *Stanford Social Innovation Review*, September 28, 2012, https://ssir.org/articles/entry/do_no_harm_subsidies_and_impact_investing.

Multiple stakeholders and observers have raised questions and criticisms about OZs that highlight the need to explore this topic. One set of concerns has to do with the selection of census tracts for OZ designation and whether investing in certain of these tracts could lead to gentrification and displacement. While on average, OZs show higher or equivalent levels of economic distress than other eligible communities that were not selected, a small number of Zones are fairly well off (Theodos 2019; Theodos, Meixell, and Hedman 2018). Precisely because the OZ incentive provides the largest rewards to projects with the largest expected returns,⁷ some stakeholders fear that developers have been focusing on the OZs that were already on the upswing, leaving more distressed areas behind.⁸ Other questions and criticisms have been surfaced by media reports of OZ incentives being used to fund luxury projects, as well as projects that were already likely to happen.⁹ Critics have also noted that incentives can be accessed without community input or any process of prioritization where local governments can ensure alignment with localized goals.¹⁰ These concerns have engendered a significant policy debate over the future of OZs, with multiple bills introduced to revise the incentive.

To understand OZs with respect to equitable development goals at this early stage and amid current challenges, we conducted close to 70 in-depth interviews with a range of stakeholders working on mission-oriented OZ projects across the country. We are not able to measure what proportion of OZ

capital is mission-driven, but rather sought to understand how OZs are playing out in that potentially small—but unknown—segment of the market. Considering the lack of reporting requirements and resulting lack of data on OZ investments, we are only able to assess the incentive based on this qualitative approach of semistructured interviews, which we believe are broadly representative of the mission-oriented OZ field. As noted, however, the Treasury has not released data we can use to describe the comprehensive distribution of OZ projects, and there are concerns that investors that do not align with equitable development goals may be less likely to make their investments publicly known.

For the interviews, we spoke with project sponsors; fund managers; investors; wealth managers; developers; philanthropies; and public and nonprofit agencies working with OZs, such as community development intermediaries, state OZ program offices, and city-level OZ coordinators. We asked interviewees to describe projects that were funded as well as those seeking funding, the terms of investment sought by project sponsors as well as investors, the nature of community engagement that they have observed, and other opportunities and challenges they perceive around using the incentive for equitable development. We found our sample of OZ projects through discussions with national and local OZ experts, the Opportunity Exchange listing of projects,¹¹ the Economic Innovation Group's Opportunity Zones Activity Map,¹² scans of news articles, examples highlighted at a number of convenings around the country (including in Atlantic City, Chicago, Cleveland, Columbia, Greenville, Miami, Norfolk, Salt Lake City, Seattle, and Washington, DC), and through a snowball sample of additional informants we became aware of.

In this report, we summarize nine takeaways (box 2) on how mission-oriented actors are using OZs. We also include seven case studies (in boxes labeled “A Closer Look”) that illustrate how some practitioners are using OZ financing creatively to capitalize mission-oriented projects. Though our sample is certainly not comprehensive and we cannot be assured it is statistically representative given there is no known universe of projects to draw from, the themes we present recurred across multiple conversations, contexts, and actors, and we believe they reflect how OZs have been deployed to support projects oriented to equitable development.

BOX 2

Nine Takeaways on How Mission-Oriented Actors Are Using OZs

1. OZs Are Reaching Actors That Had Not Been Engaging with the Community Development Field
2. OZs Are Catalyzing an Ecosystem of Community Development Efforts
3. The OZ Structure Lacks Encouragement for Resident or Intermediary Engagement

4. Many Mission-Based Project Sponsors Are Struggling to Find OZ Investors
 5. OZ Investors Demand Higher Returns Than Impact Projects Can Provide
 6. OZs Were Designed to Spur Job Creation, but Most of Their Capital Is Flowing into Real Estate
 7. Even for Real Estate, Exit Strategies at Year 10 Raise Challenges for Project Sponsors
 8. To Drive Impact, OZs Often Need to Be Paired with Other Subsidy Sources
 9. The Need for OZ Financing in OZ Projects Is Mixed
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We find that OZs are helping spur the evolution of a new community development ecosystem, engaging both project developers and investors who have limited historical engagement in community development work. Despite this catalytic effect, however, we also see that many mission-oriented actors are struggling to access capital. Many project sponsors are struggling to access the class of investors—wealthy individuals and corporations with capital gains—for whom the OZ incentives are tailored. Additionally, many mission-oriented projects yield below-market returns that most OZ investors appear unwilling to accept. As OZ incentives are not structured to encourage resident or community engagement, mission-oriented projects struggle to compete for attention with higher-return projects—for which OZs provide much larger financial support in the form of greater tax expenditures.

A further challenge for mission-oriented projects is that the sponsors are seeking to support a community asset with a lifetime well beyond the 10-year time horizon of the OZ incentives. Given that an illiquid investment over a 10-year horizon is already challenging for OZ investors, the type of investment many mission actors need and the OZ market's investment parameters are mismatched. Because of these challenges, we mostly saw mission-oriented projects succeed in using OZs when the capital stack also layered in significant other subsidy sources, or when a well-connected project sponsor was able to locate an investor willing to accept significantly below-market returns.

Although OZs were designed to spur job creation, the vast majority of capital appears to be flowing into real estate, not into operating businesses, because of various program design constraints and the undesirability of selling equity from both the business owners' and the investors' perspective. Ultimately, most developers and investors view OZ incentives as a relatively small boost on overall returns. The incentives have had mixed effects on making projects work that would not otherwise happen. Some developers reported that the incentives did make a decisive difference in allowing a project to go forward, while others were clear that their project would have proceeded with or without

the OZ equity. Most observers appear to agree that a primary benefit of the program is that it elevates the visibility of neighborhoods and deals that investors might not have considered otherwise.

Taken together, these results ask policymakers to reflect on the goals of OZs. To the extent that OZ incentives were intended to foster equitable development outcomes—such as by creating quality jobs, affordable housing, community-oriented amenities like grocery stores, and improved quality of life for low-income people—our evidence suggests they need to be redesigned so government dollars are allocated effectively and help project sponsors achieve those outcomes.

The COVID-19 health crisis, and the economic recession it is causing, add significantly to the list of challenges for practitioners looking to use the OZ incentive. Investment in operating small businesses will face particular strain, but consequences will radiate to the financial sustainability of real estate, both commercial—which relies on rents from shuttered businesses—and housing—which relies on rents from residents who may have lost jobs or face a cutback in hours. At the same time, the crisis may provide an opportunity to rethink and redesign the OZ incentive so it can play a stronger role in helping hard-hit communities recover.

Nine Observations on the OZ Program’s Deployment

1. OZs Are Reaching Actors That Had Not Been Engaging with the Community Development Field

The OZ tax incentive was designed to generate a broad marketplace of investments—free of the restrictions built into previous federal programs, such as the Low-Income Housing Tax Credit (LIHTC) and the New Markets Tax Credit (NMTC), that also sought to draw capital into disinvested communities. Almost any individual or corporation with capital gains can invest in a qualified opportunity fund, and there is no cap on the amount of OZs incentives that can be claimed. (See the appendix for an overview of how the program operates.) We don’t know how large the program will become; Treasury Secretary Steve Mnuchin estimated in 2018 that OZs could attract as much as \$100 billion in private capital, though the investment climate has changed since then.¹³ Additionally, OZ incentives encourage equity investments over a relatively long-term investment horizon—generally 10 years. Since long-term equity financing can be difficult for developers and businesses to obtain, OZ incentives could unlock particularly valuable forms of capital.

The OZ legislation is trying to [change the] habit of investors who have historically relied on precedent to make business decision. It's trying to steer their eyes towards new areas, new risk profiles, and new equations. —Fund manager

It is no surprise that the OZ incentive has attracted interest from actors across the country, including those engaged in equitable development. The flexibility of the program has resulted in a range of mission-oriented projects that are using—or at least seeking to use—the incentive. Some of the impact areas in which we see interest or activity include affordable housing, health care, food and agriculture, arts, small business development, renewable energy, and neighborhood revitalization. Notably, many (although certainly not all) of these projects are happening outside the auspices of a community development corporation (CDC) or community development finance institution (CDFI). It also appears that Black communities are particularly engaged with the program. We interviewed many Black entrepreneurs, with roots outside the community development industry, who have been seeking OZs funding. To be clear, not all these projects and sponsors have accessed funding, but their interest and activity are notable. Examples include

- real estate developers in Chicago, Seattle, and Washington, DC, building affordable housing and mixed-use projects;
- a group seeking to increase access to Small Business Administration (SBA) 504 financing for Black-owned businesses in North Carolina;
- a real estate developer raising OZ equity for mixed-use projects near historically black colleges and universities across the country;
- a family office manager channeling capital into a workforce development facility in the South Side of Chicago;
- a health care professional poised to become one of the first Black female real estate developers in Greenville, NC; and
- a marine biologist volunteering to help develop a food bank in South Carolina.

Our informants also raised the case of Our Opportunity, a QOF created by a half-dozen NBA players seeking to raise \$300 million for OZs in Chicago and Cleveland, where many of them grew up.¹⁴ One interviewee believes that the interest in the Black community in this program has to do with “the

way that Black developers have been treated—the level of under-capitalization has been shameful and the financial products for them in the past were a poor fit.” In this context, it is important to note that Senators Cory Booker (D-NJ) and Tim Scott (R-SC) introduced the Invest in Opportunity Act that birthed OZs.

We also interviewed people from other demographic groups with little background in the mainstream community development industry who are now using, or seeking to use, OZs for equitable development. These interviewees included a musician who is obtaining OZ financing to redevelop a theatre in Birmingham, Alabama; a NASA engineer who became a part-time solar entrepreneur after volunteering on a project to bring solar power to her children’s school; and a grassroots group seeking to develop tiny homes for the homeless. None of these groups are working with CDCs or CDFIs.

On the investor side, one project sponsor with experience developing workforce housing explained that before OZs, his firm had been “relegated to CRA lenders and social impact-related investors.” “We [now] have a broad array of investors that are taking the time to understand these complicated capital stacks where before they probably wouldn't have.” These new investors who have been attracted to impact investments include family offices, high-net-worth individuals, and other people with capital gains. Individuals who had sold a Dunkin’ Donuts franchise used their capital gains to invest in an OZ where a Black developer completed an adaptive reuse development (Weiss and Katz, n.d.). The NASA engineer-turned-solar-developer is investing personal capital gains as the OZ equity. These stories are emblematic of the kinds of investors who have not previously invested in mainstream community development finance programs.

The community development system had become complacent—it was putting out widgets. So was conventional venture capital and private equity. [OZ] is bringing in new classes of investors—really different ideas are getting put on the table now. The people working on this are not the traditional community development people.—OZ consultant

Meanwhile, some traditional community development actors, including many CDFIs, have been less engaged with OZs than they were with other federal programs. As the Opportunity Finance Network, an association of CDFIs, reported, “relatively few CDFIs are moving forward with establishing their own opportunity funds” because of various challenges with the OZ program structure (Vasiloff 2019). Most

important, as other observers have noted, OZ incentives are for equity, but CDFIs tend to operate as lenders (Tansey and Swack 2019). Even for CDFIs willing to deploy equity, deployment rules create compliance risk for multi-investment funds that must be carefully managed.¹⁵ That said, a small set of CDFIs have developed or are seeking to develop equitable development-oriented QOFs. CDFIs like AltCap, CEI, Community Reinvestment Fund, Enterprise, Local Initiatives Support Corporation (LISC), and New Jersey Community Capital have formed—or are in the process of forming—their own QOFs with the goal of using OZs incentives to promote inclusive, equitable development. The vast majority of CDFIs, however, have not entered the OZ market directly (Vasiloff 2019).

2. OZs Are Catalyzing an Ecosystem of Community Development Efforts

OZs have also brought together coalitions that are impressive in the diversity of actors engaging in them. The incentive has engaged federal agencies, states, localities, investors, fund managers, developers, philanthropies, and community groups to an extent arguably unseen with other federal economic development initiatives.

The [White House Opportunity and Revitalization Council](#) has sought to align incentives and integrate OZs across other federal agency processes and programs. For instance, the Economic Development Administration includes OZs as an “investment priority,”¹⁶ and the Federal Housing Administration provides a series of incentives to encourage multifamily development within OZs.¹⁷

Several states, regions, and cities have set up nonprofit OZ intermediary organizations to match projects and investors. These organizations include [Invest Acadiana](#), [Opportunity Alabama](#), [Opportunity Appalachia](#), and [Opportunity Virginia](#). These organizations educate communities within their service area about OZs, build out inventories of social impact projects looking for OZ funding, help guide projects become investor ready, and curate potential investors serving a matchmaking role. For instance, Opportunity Alabama is tracking more than 300 potential OZ projects throughout the state at various stages of development and has so far helped close at least nine OZ deals. As one coordinator described: “Once OZ capital is connected to the project, we work with that project and its investors to bring the other sources of capital into the project to get it across the finish line. We look at all available sources we can bring to the table... banks, CDFIs, foundations, LIHTC, NMTC, state and local incentive, enterprise tax credits—and we help to make sure partners are aware of one another.”

A number of cities have designated OZ coordinators to build localized pipelines of mission-oriented projects, serve as matchmakers between potential investors and projects, and help convene potential sources of capital. In places like Baltimore¹⁸ and Kansas City,¹⁹ philanthropy initiatives are funding

these positions. The Rockefeller Foundation’s grant for “community capacity building” helped cities hire a “chief Opportunity Zone officer” and community engagement specialists “to facilitate community involvement in the proposed Opportunity Zone projects and businesses.”²⁰ In other cases, such as Norfolk, VA, and Washington, DC, designated city staff have taken up this work. A handful of cities, states, and intermediary organizations have launched integrated platforms (e.g., using partners such as the [Opportunity Exchange](#)) to allow for investor-project matchmaking.

States have also aligned or created new incentives around OZs and supported local community planning through grants (Theodos, Evans, and Meixell 2019). One of the most substantial efforts has been Alabama’s Incentives Modernization Act, which created a series of benefits for state-certified QOFs that meet specific impact investing standards. These funds receive the state capital gains tax benefits on OZ investments, can seek investment from 10 state pension funds (but these funds, as non-taxable entities, do not receive the OZ benefit), and are eligible for a \$50 million tax credit pool to offset losses and guarantee returns on mission-oriented projects.²¹ Maryland offers enhancements to other state tax credit programs for qualified OZ businesses if they agree to provide the state with transaction-level reporting, and additional enhancement for projects that have a community benefits agreement or community residents on their governing/advisory board and provide a resolution/letter from their locality or county.²² Louisiana has expanded its [Restoration Tax Abatement](#) program (which previously applied only to specific designated districts) to all Opportunity Zones within the state. This program allows for an up to 10-year abatement of property taxes for renovations and improvements to commercial structures or owner-occupied residences. Other states, such as New Jersey through its [OZ Challenge Program](#), have provided technical assistance grants for smaller cities to help prepare economic development strategies around OZs.

Nonprofit organizations have also promoted the use of OZs for positive social impacts in different ways. The Kresge Foundation is providing \$22 million in guarantees to two impact-focused QOFs (Arctaris Impact and Community Capital Management) that have committed to detailed reporting, transparency, and community engagement.²³ The Foundation has also supported an incubation program through Calvert Impact Capital for mission-based finance groups exploring becoming QOFs.²⁴ Other organizations are bolstering city government efforts to use OZs in pursuit of social impact goals. The Rockefeller Foundation and Smart Growth America launched an Opportunity Zones Academy that provides five cities with technical assistance, connections to impact investors, and a peer learning network.²⁵ The Mastercard Center for Inclusive Growth and Accelerator for America have partnered to help 50 city leaders build OZ investment prospectuses, track economic activity, consult, and generate a needs analysis.²⁶ Groups such as Enterprise Community Partners, Governance Project, LISC, and

NeighborWorks America have developed technical assistance resources, led convenings, or funded nonprofit community development groups around OZ issues. Further, the growing OZ ecosystem has spurred countless local, state, regional, and national conferences and work sessions. Investors, fund managers, developers, accountants, and tax lawyers have convened frequently to discuss the details of the incentive and potential deals that could result: recent conferences and OZ working groups convened by the Economic Innovation Group and Novogradac are examples.

The vast range of engaged stakeholders and depth of these engagements is noteworthy. However, the ultimate investment results of these many-actor efforts are not yet clear. A fund manager cautioned against overhyping the value of these initiatives: “I don’t buy that this will have an enduring ecosystem effect. People check the box a lot, like naming people czars, but they don’t fundamentally change the way they work.” A CDFI practitioner agreed: “I think the marketplaces got hyped up too much... Certainly, convenings and networks are good because they help create important connections, but I’m skeptical about their impact, particularly because I think there is such a thing as too many networks, and we see that now with people not knowing where to go find deals.” This investor considered local government dedicated positions on OZs the most effective among the array of initiatives to foster OZ activity, mission-oriented or otherwise: “I can pick up the phone and ask the OZ coordinator directly about deals in her or his city,” he added.

Other interviewees were less certain that local OZ coordinators were facilitating investment. Many coordinating and facilitative structures have yet to demonstrate a consistent ability to connect projects to capital. One statewide investment coordinator we spoke with had been able to get only one project to closing so far out of 200 projects they were attempting to assist.

A CLOSER LOOK: Tribal Communities Come Together to Leverage OZs

North Star Opportunity Zones, Northwest Washington

Five communities in North Central Washington decided to pool resources to lift up their OZs. Chelan County, Colville Tribes, Douglas County, Ferry County, and Okanogan County created the NorthStar Opportunity Zones initiative to leverage the incentive in service of single- and multifamily housing, as well as economic development. Some projects they have already identified are an inpatient alcohol and drug treatment center, an industrial campus, a technology incubator, the renovation of a 1906 building that used to serve as a city jail, and a planned unit development campus.



Mill Pond Industrial Park, one of the projects NorthStar Opportunity Zones is seeking capital for. Photo credit: NorthStar Opportunity Zones.

The communities joined forces to solidify their standing before the scrutiny of potential investors, and to avoid having communities and tribes raising capital individually project by project. Given some challenges around sovereignty, partnerships, and dispute resolution that may affect these particular communities, North Star sought the support of the North Central Washington Economic Development District to create and launch the prospective multi-asset QOF as a blind pool fund that could support the many different project prospects of all the communities. The North Central Washington Economic Development District helped convene stakeholders for designing the QOF, while Washington State University Ferry County partners led the effort to recruit financial partners. The North Central Washington Economic Development District is also planning on using OZ equity to finance a business launch competition, focusing on growing small and mid-sized businesses in the region.

3. The OZ Structure Lacks Encouragement for Resident or Intermediary Engagement

Since the Model Cities program began in 1966, federal programs targeting resources to disinvested communities have incorporated measures intended to ensure that residents have a voice in how resources are employed in their community. The Empowerment Zones program, for example, which provided both grants and tax incentives for business expansion, required cities to prepare 10-year strategic revitalization plans in consultation with the community. The Community Development Block Grant program requires cities to prepare “consolidated plans” which “provides for, and encourages... participation by residents of low- and moderate-income neighborhoods.”²⁷ LIHTC provides state

governments with the opportunity to develop allocation plans that prioritize certain types of projects over others, presumably based on input from citizens. The NMTC program requires that the Community Development Entities that receive allocations of these credits create advisory boards with members from the communities they serve or representative of the communities.

The OZ incentive is distinctive in that, as implemented by Treasury, it allows QOFs to self-certify, meaning they are not required to have a social-impact mission, nor to be governed or advised by community members. Despite involving a significant potential expenditure of taxpayer dollars, the OZ program provides no opportunity for citizen input about proposed projects, or even a role for a state or local government—or any other entity that might be accountable to low-income community residents—to prioritize the types of projects that should receive incentives once the state government has selected its Zones. Tellingly, some state and local OZ coordinators we interviewed noted that some development projects have gone forward without their office’s support.

Despite the lack of requirements in this regard, we did find creative instances of sponsors engaging with community members around OZs, although processes involving community planning were largely carried out before the OZ program was even announced.

- A hospital gave a \$100,000 grant to local CDCs for facilitating a neighborhood master planning process, which is helping determine the community development program the hospital will implement with support from OZ investors.
- A CDC that uses grassroots community engagement and planning processes to inform its real estate development work is seeking OZ financing for a grocery store in a high-poverty neighborhood.
- A private developer described using a community planning process to determine the best mix of land uses and amenities.
- A project sponsor developing a high-tech vertical farm is working with the local school system to use the project as a STEAM (science, technology, engineering, arts, and math) learning opportunity for children.

Ultimately, based on our interviews, we heard that mission-driven OZ actors are using similar community engagement strategies that they might for other federal community and economic development programs like CDBG, LIHTCs, NMTCs, or programs run by the EDA or USDA. The difference between OZs and these other programs is that many OZ projects cannot easily be characterized as mission-oriented or in line with equitable development. The lack of community

engagement is a more significant issue as there are not intermediaries to guide or require OZ projects to align with community needs even if they do not engage community members—in fact, OZs do not even require sponsors to inform communities about their projects. At the same time, OZ proponents argue that requiring some form of community engagement would create a barrier to the flow of capital, rendering OZs ineffective.

A CLOSER LOOK: Empowering Zone Residents and Business Owners

We Grow KC, Kansas City, Missouri

The Kauffman Foundation, the Kansas City Chamber of Commerce, and the Urban Neighborhood Initiative came together to form We Grow KC, a group working with community residents to bring investment to Kansas City's OZs in a way that facilitates community ownership and benefit.

Starting in late 2019, We Grow KC has held a series of deep community engagements with Zone residents, business owners, and aspiring entrepreneurs. These sessions provide residents with details on how OZs function and then strategize block by block to identify community gaps and needs. After identifying these needs, We Grow KC works with local businesses and project sponsors to identify projects that could leverage OZs, as well as other financing strategies, and matches projects and potential investors. We Grow KC has also brought the [Opportunity Zone Impact Assessment Tool](#) to community sessions to model and discuss the potential benefits and trade-offs of various projects. To address investor minimum capital thresholds, the group is bundling sets of smaller projects along the same street or street corner.



*The 18th and Vine neighborhood of Kansas City, MO.
Photo credit: WeGrowKC.*

Additionally, Zone residents are unlikely to influence projects in their community by taking on a role as investors. Ninety-four percent of taxable capital gains in the country are in households with gross incomes above \$100,000.²⁸ Meanwhile, only 12 percent of OZ residents have household incomes above \$100,000,²⁹ making it highly unlikely that they invest in projects affecting their own communities. At the end of the day, people from outside Zones will largely be making investment decisions that affect Zone residents. The exception is projects sponsored by CDCs or other community-based nonprofits, which may have board-level accountability to the community as well as a charitable mission to meet. Depending on their state and city, residents can influence organizations to undertake OZ projects that

meet their interests through development entitlements and permitting. But neighborhood control, zoning processes, and approval rights vary widely across the US, for example as illustrated between Home Rule and Dillon's Rule states.³⁰

Community engagement could add a year or two to the project timeline, so that's difficult, and when you layer in the OZ timeline, it becomes almost impossible. –CDFI practitioner

4. Many Mission-Based Project Sponsors Are Struggling to Find OZ Investors

As mentioned before, OZs were designed to reach different investors than what many other community development programs have attracted. Potential OZ investors include institutional investors, family offices, high-net-worth individuals, banks, and basically any individual or corporation with capital gains. As broad as this pool may be, most mission-oriented practitioners that we spoke with reported difficulty building relationships with potential investors. As one project sponsor reported: "It's not an easy process—[the money] is not exactly flowing like water." The reasons mission-oriented sponsors are experiencing these challenges are varied and include the following.

Lack of connections: For many project sponsors the difficulty finding investors stems from OZ equity being limited to capital gains; this reduces considerably the pool of investors to which sponsors can appeal for funds. According to Tax Policy Center estimates for 2018, fewer than 10 percent of taxpayers reported long-term capital gains. These taxpayers are overwhelmingly concentrated in the highest income brackets. Only 1.4 percent of taxpayers in the lowest income quintile, and 3.6 percent in the second-lowest income quintile, reported long-term capital gains.³¹ This limitation may be less decisive for developers of market-rate projects, as developers may have their own capital gains to invest or know others who do within their social and business networks. For project sponsors whose networks do not encompass taxpayers with capital gains, this limitation can be crippling.

Examples from our interviews include a developer trying to create permanent rental housing for people experiencing homelessness in a West Coast state. The developer shared that they were not getting any feedback from OZ investors, and added "the Opportunity Zones concept requires a particular type of investor, and we are not in the social or political networks to connect with those types of people. It's been a disappointment." Another project sponsor lamented: "I grew up on a rural farm—I didn't meet a lot of venture capital types." An interviewee from a social impact equity fund that had

considered—but is no longer pursuing—working with OZ investors felt that one barrier was a lack of connections within the right investment circles—even though this fund offers attractive returns. “We know foundations and banks more than we know high-net-worth individuals who happen to have had large capital gains in the last six months,” they said. In a capital-raising success that is equally telling, one interviewee was able to raise \$500,000 in capital from wealthy investors who sit on his board and through personal connections. The interviewee commented, “Are you ever going to be able to be a dude off the street and get some family office money? Probably not.”

Earlier, we noted that many Black project sponsors have sought to engage with OZs. While some of these sponsors have been successful, others have felt that patterns of discrimination have made it hard to connect with investors. A developer of color seeking what he described as “market rate” returns to build green workforce housing in the Midwest was unable to get a single meeting with a family office, despite years of experience running a US platform for an international investment group, and putting together what they described as an “institutional-grade due diligence package.” The developer felt that among the for-profit institutions, family offices, and high-net-worth-individuals who have capital gains, “their doors have not been open to women and minority developers. Doors are closed to us, and that’s been the case for other folks too.” While some Black developers report positive interactions with the program, the experience of exclusion is also consonant with research suggesting that funds led by high-performing Black men are the most harmed by racial bias from asset allocators, even when all other fund aspects are identical (Lyons-Padilla et al. 2018).

Track record and experience: As OZs have attracted new actors into the community development space, part of the struggle to connect with investors has to do with project sponsors’ track record and inexperience working with investors. An OZ fund manager commented, “The basic fluency with investment and numbers and business models, and the capacity of [these] developers to talk to people with investment capital is just not there... I see a big opportunity to bring investment fluency to developers in neighborhoods who are new and coming to the table for the first time.” A fund manager at a CDFI agreed: “Even if you know investors to pitch your project to, the difficulty does not come from the scale of the project so much as it comes from your capital readiness. How well are you capitalized and what is your track record for doing these projects? They need to be better prepared to present the pitch. This is where TA or philanthropic money could come helpful to make these smaller sponsors be capital ready.”

Project sponsors who have a track record, and enjoy high visibility and trust from local stakeholders, report more success. A health care system shared they had “banks pounding on their door” to invest in a mixed-use project including affordable housing near their hospital campus. In a

different example, a fund created to provide equity for real estate collateralized SBA 504 deals has raised \$7.5 million in equity from a family office and expects to raise another \$5 million from banks.

Transaction costs: Transaction costs—such as legal and accounting fees—have long presented hurdles to accessing capital through other community development programs, such as LIHTC and NMTC. Though the OZ program is indeed simpler than community development tax credits, it is not immune to transaction cost barriers. These costs can include elevated search costs—such as hiring a broker to find investors—in addition to legal and accounting costs to set up a QOF. “I spent a lot more on accountants and lawyers than I thought I would,” said one developer.

Deal size: Any investment that carries significant transaction costs needs to reach a certain scale before the transaction costs are worth it. Interviewees confirmed that sponsors usually need a relatively large deal to attract interest, at least from institutional OZ investors. A project sponsor emphasized the importance of project scale: “if you are not doing a large-scale project that is going to be able to generate strong market rate returns, your typical funds are not interested.”

Return: For many mission-oriented actors, their projects simply do not generate a return high enough to interest many investors. This dynamic is so important we devote the next of our nine observations to discussing it.

Opportunity Zones investors are for-profit institutions, family offices, and high-net-worth individuals with capital gains. Their doors have not been open to women and minority developers for years, so who is getting access to this capital? –Real estate developer

A CLOSER LOOK: Partnering with Wealth Advisors to Raise Capital

City Foundry, St. Louis, Missouri

Lawrence Group, an architecture and construction firm, is developing City Foundry STL Public Market, a large mixed-use development that will include a food hall, offices, grocery, entertainment, dining, theatre, and space for nonprofit groups. City Foundry is on a 100-year-old industrial brownfield site in the Midtown area of St. Louis. The project was born in 2015 when the property was acquired, and from 2016 to 2018 Lawrence Group worked on the environmental clean-up, early design, early leasing, and adding the property to the National Register of Historic Places to access the historic rehabilitation tax credit (HTC).



Photo credit: Lawrence Group.

Lawrence Group struggled initially to form its capital stack; potential investors were interested in safer projects, such as multifamily housing or projects in the major coastal markets. Although Lawrence Group was able to secure the HTC and some debt pledges, the latter were conditional to higher levels of equity, something the sponsor was not in position to provide himself. In 2017, the stack had a gap of \$39 million—17 percent of the \$230 million total project costs. The sponsor approached CliftonLarsonAllen Wealth Advisors, an accounting firm with which it had a working relationship, to help raise capital through OZs. Already a leader in the OZs field, CliftonLarsonAllen helped Lawrence Group with the OZ financial modeling of the project (both from the tax and financial standpoints) and facilitated relationships with potential investors with sizable capital gains. Between January 24 and June 13, 2019, the single-project City Foundry QOF was able to raise \$50 million (\$11 million more than what was needed), mostly from investors outside St. Louis who were monetizing the sale of businesses. The additional OZ equity allowed the sponsor to lower the debt in the capital stack. Although this meant less ownership of the project for Lawrence Group, according to the firm, “it created a much safer project to handle the stresses of the current health crisis.”

The final capital stack was \$50 million from OZ equity, \$10 million from sponsor equity, \$40 million from the HTC, and \$130 million from loans, one of which was provided by St. Louis University, a neighbor of the development and anchor institution for the surrounding community. The projected internal rate of return after tax through the 10-year hold is 14 percent. The first City Foundry tenants had planned to move in on April 2020, but the COVID-19 crisis has put the process on hold for now.

The difficulties in raising capital that mission-driven actors have faced is particularly troubling given that many actors have made substantial investments in structures and institutions to facilitate OZ investment. It remains to be seen whether these challenges are temporary ones that will resolve as these facilitative structures gain traction. One optimistic interviewee felt that fund managers “will eventually get their sea legs. They are not there yet, but with time.” On the other hand, as mentioned above, one interviewee who was trying to raise OZ equity for a list of 200 high-social-impact projects had closed financing for only one project as of January 2020. A key question is whether this type of market-making infrastructure can reach maturity in time, given that, as several interviewees noted, the value of the OZ incentives is already decreasing as we approach 2026, and COVID-19 has caused significant market disruptions.

A CLOSER LOOK: Raising Local OZ Capital

Fredericksburg Food Coop, Fredericksburg, Virginia

A key challenge smaller community-oriented high social impact projects have faced is the inability to attract OZ capital at below-market returns. Fredericksburg Food Coop is attempting to overcome this hurdle by focusing on attracting smaller donors with strong interest in helping their local community.

The Fredericksburg Food Coop has raised slightly more than half (\$1.7 million) of its total development cost from one-time membership fees of future consumers who now are part owners of the coop. Other businesses in this situation might turn to mainstream debt financing for the remaining \$1.5 million, but start-up coops often have difficulty accessing this source because of their nontraditional business model. The Fredericksburg Food Coop has turned to OZs as a potential solution by creating a \$1.5 million QOF. Start-up risks, the nontraditional model, and below-market returns made attracting interest from existing QOFs difficult. By creating its own fund, the coop is seeking to tap into a new market of investors with local interests. Though most QOFs have minimum buy-ins of \$100,000 to \$1 million, the coop’s fund has a minimum investor holding of \$10,000.



Photo credit: City of Fredericksburg, VA.

5. OZ Investors Demand Higher Returns Than Impact Projects Can Provide

After the challenge of finding and connecting with potential investors, sponsors of mission-oriented projects are finding themselves with requests for market-rate (12–16 percent) or near-market-rate returns (8–12 percent). These internal rates of return (IRR)—even near-market—are in most cases unachievable for sponsors of mission-driven projects, creating frustration for sponsors about what they feel are unrealistic investor expectations. One Florida-based affordable housing developer relayed: “When we’ve talked to Opportunity Zone investors before about the transactions they want, the yields are something we can’t produce in affordable housing, and the amount of developer fee they want for us is too small. Their expectations are not realistic. You need to be an impact investor. A typical LIHTC investor gets maybe a 6 percent IRR. These folks were asking for double digits. There’s no way to squeeze that out of a LIHTC deal.” A health system related the same problem: “I hear at conferences from investors about their return expectations of 7 to 10 percent [pre-tax]. We can’t generate that kind of return.”

Many mission-driven practitioners we spoke to had projected IRRs between 3 and 7 percent. These practitioners are on a quest to find “real impact investors, not folks demanding double-digit returns.” As another put it, the projects need investors who are “driven by community benefits as well as return.” We found a few examples of such investors. One interviewee set up a small solar energy QOF with her own money. She was making 1 percent a year of total return (as detailed in the box A Closer Look: Increasing Benefits of Below-Market-Rate Social Impact Projects), but her real motivation for the project was tackling climate change. She also explained that investing in this QOF was a better alternative than simply donating money, which she cannot do with 10 percent of her wealth. “It’s so sustainable as a funding strategy,” she added.

Unfortunately, however, this approach to investment and returns is an exception among the cases we studied, and it appears that very few investors are willing to adopt it. One frustrated nonprofit affordable housing developer in a West Coast city exclaimed: “I question whether there really is an impact investing community. I’ve been on the circuit and it is clear to me that people want both high impact and market rate return. So then who pays for the impact? They expect us to go out and raise grant money to offset their returns, instead of them being willing to take less return.” Another community development nonprofit seeking support for two mixed-use projects in a high-poverty location reported talking with institutional investors wanting 10 percent returns before the value of the tax incentives. “That doesn’t do anything for us,” she related, “It just pushes the problem down the road.” That organization has since pitched several families who have made donations in the past about a below-market impact investment. Other community developers have resigned themselves to seeking

other funding for the projects. One community planner commented: “I don’t see [OZs] as being a real strong fit unless the social impact reporting requirement changes. The margins on businesses we are working on (like a drug treatment center) really require a mission driven investor.”

When we talk about workforce housing they are not interested. Investors either want high returns or donate their money for homeless housing. There’s not a connect between people’s motivation and their financial structure. –Real estate developer

Why do most investors demand double-digit pretax returns for OZ investments? Several factors are in play:

- **Incentive architecture:** The OZ benefit structure is a significant factor driving investor goals for return. The inherent economic incentive of OZs is to start with a low capital account and exit with the highest gain possible. OZs are designed to provide the largest subsidies to projects with the highest returns, rather than the highest social impact. This is because the largest component of the OZ incentive is that gains are tax-free: the larger the gain, the larger the financial support in the form of forgone tax. In other words, high-end apartment buildings and hotels can be expected to access larger incentives, as a percentage of project costs, than food banks, supermarkets in food deserts, or affordable housing projects. This fundamental design was reflected in our conversations with sponsors of mission-driven projects and their frustrations with the program.
- **Ten-year hold:** A critical factor driving investor return expectations is the need to compensate for the long holding period of OZ investments. For investments held for at least 10 years, investors pay no taxes on any capital gains produced through their investment in a QOF. However, during this 10-year holding period, investments are illiquid. Investors naturally respond to long, illiquid holding periods by boosting the returns they demand. As an OZ fund manager observed, “given that their investment will be illiquid for 10 years, almost every investor has a minimum return threshold of 10 percent net before the OZ benefit.” Another fund manager further explained, “A developer cycle is usually 3 to 5 years, so you are asking them for 5 to 7 more years.” Providing for an earlier exit would likely reduce demands for

return, but if anything, mission-oriented actors are seeking more capital that is patient for more than 10 years, not less, as we discuss in observation 7.

- **Shallow subsidy:** In the eyes of most interviewees we spoke with, OZ is a relatively shallow subsidy that is adding somewhere between 150 to 300 basis points to the return for most deals. Thus, for a typical project, the incentive is not enough to provide the return that investors seek. As one fund manager described, “you will hardly see the OZ incentive turning a project with a 5- to-8 percent return from a ‘no’ to a ‘yes,’ but it may happen with a project with a 10 percent return.” For that reason, mission-oriented projects generally have to layer other subsidies with OZ incentives, a theme we explore in more detail in observation 8.

A CLOSER LOOK: Opportunity Zones Can Finance Small Community Projects... with the Right Connections

Mason Music Foundation & Woodlawn Theatre, Birmingham, Alabama

When an old movie theatre in the Woodlawn neighborhood of Birmingham, Alabama, went up for sale, the owner of Mason Music realized it could be the perfect dual-location for his new business. He envisioned an offshoot of Mason Music as a performance venue and a nonprofit that provides scholarship-based music lessons for low-income students who could not otherwise afford them. He sought to leverage OZ investment to buy the property. Five investors, all Birmingham locals, provided roughly \$150,000 in OZ financing, more than covering the \$125,000 price of the building. The remaining \$350,000–\$400,000 in rehabilitation costs was financed through a traditional bank loan.



Photo credit: Bham Now.

Investors will be paid an annual internal return of roughly 4 percent in addition to proceeds upon buyout of their shares in the theatre. Mason guaranteed the investors the chance to sell off their ownership of the property at year 10. If they choose to sell, he hopes to be able to buy out their share or find others willing to. In the worst-case circumstances, Mason would sell the building. With confidence in the appreciation of the real estate investment, and a guaranteed 10-year exit option, investors were willing to accept a lower annual return than they might have otherwise. Mason understands the ownership group of the building may change at year 10, but he intends to find a way to operate the music venue and nonprofit into the future.

This type of small and relatively unusual project would be difficult to finance through more conventional community development dollars like NMTCs. The investor-to-project matchmaking relied on the project sponsor's connections (including members of the Mason Music Foundation's board and parents of students at Mason Music). This makes the deal less transferable to other small locally focused social impact projects, particularly for long-disinvested neighborhoods with less social capital.

Mason reports that due to the COVID-19 crisis, "we have a temporary hold on the project until we know when large gatherings will be possible again."

6. OZs Were Designed to Spur Job Creation, but Most of Their Capital Is Flowing into Real Estate

According to the IRS, "Opportunity Zones are an economic development tool—that is, they are designed to spur economic development and job creation in distressed communities."³² However, the majority of OZ projects appear to be focused on real estate transactions, not direct investments in operating businesses. According to Novogradac's data on 621 QOFs, only 4 percent are focused on investments into operating businesses.³³ These statistics appear to also apply for mission-oriented OZ investments; very few sponsors we spoke with were working with operating businesses. One successful fund sought to provide minority-owned businesses in North Carolina access to SBA 504 financing. The equity will still be used to purchase real estate rather than investing directly in the businesses, although it will be owner-occupied space.

Both deployment rules and rigidity around investment time frames to access incentives appear to have hindered the use of OZs for equity investments in operating businesses. Investors have 180 days to invest in a QOF, and the QOF has to deploy the capital in a set time frame. The QOF can choose not to deploy all the capital at once, but it has to at least have a schedule of when to deploy. The QOF also must have 90 percent of its funds deployed at any one time. These rules create timing issues on both the front and back ends of a QOF when investing in a business, in stark contrast to venture capital. On the front end, investors with a capital gain are looking to deploy immediately, whereas a venture fund wants to obtain capital commitments and draw them only as they are needed. On the back end, OZ investors generally want to stay in a deal for 10 years, to maximize the tax benefit, and exit as soon as possible after that. A venture fund, however, exits an investment whenever the time is right to sell the business to a new investor. This makes it difficult to maintain the minimum capital deployment levels required by the IRS.

For start-up operating businesses, it may be easier to raise investment with a short time horizon. We spoke with a start-up company looking to manufacture affordable homes from shipping containers. The company found that it was unable to raise OZ equity for the first years of the project, largely because initial investors were unwilling to stay in what wealth advisors appear to see as a “risky, oddball investment” for 10 years. Instead, the company is raising \$8 million in private equity that seeks an exit after 18 months, and it is planning to use OZ equity to buy out the initial private equity in a second round of capital raising.

Investors might be interested in a stable, long-standing business where equity can be invested, left for 10 years, and then taken out easily, but these are not the businesses that most need the investment promised by the OZ program. Even if an investor is willing to leave the money in an operating business for 10 years, structuring the equity exit requires great creativity. As one investment professional related: “How can we figure out a way where you get your equity back whether it's through equity repurchase, whether it's through us bringing in other partners to the deal. That's not an easy thing to solve for. I think that's part of why it's been so hard to get operating businesses included in the Opportunity Zone framework.”

Nor is OZ equity an ideal fit for microbusinesses, which are disproportionately owned by people of color (McKay 2014). As Jennifer Vasiloff of the Opportunity Finance Network noted in her congressional testimony: “From the perspective a small business, it is daunting to give up significant ownership in a business to an unknown investor and substantially improving all of a business’ existing assets is unlikely to be a prudent expenditure. Some of these businesses would be better served by an affordable small business loan from a CDFI or other financial services institution” (Vasiloff 2019, 2). Moreover, few small businesses are able to generate the kind of growth that would provide attractive returns to equity investors. We add to these concerns that the 10-year exit investors seek could require sale of the business to a new owner. Investing in the real estate occupied by small businesses is helpful but hardly a complete solution to their financing needs—and again, the issue of what would happen to the real estate at the end of the 10-year timeline arises. The investor and the business owner may also need to come up with a way to split the tax benefits.

Ultimately, as the program figures itself out, I think you'll see more movement towards operating business, but the safe bet right now is one that does have a real estate component.
—QOF manager

A CLOSER LOOK: Increasing Benefits of Below-Market-Rate Social Impact Projects

Norfolk Solar Qualified Opportunity Zone Fund, Norfolk, Virginia

Clean energy projects are one area outside traditional real estate where OZ dollars have flowed. Norfolk Solar Qualified Opportunity Zone Fund finances the installation of solar panels on the roofs of businesses and nonprofits within OZs in the Hampton Roads region of Virginia. Panel installations are funded 30 percent through the federal Solar Investment Tax Credit, 30 percent through accelerated depreciation via the federal Modified Accelerated Cost Recovery System, and 40 percent from the electricity costs of panel recipients.



Photo credit: Norfolk Solar.

The installer bills recipients at the same rate they were paying for electricity and increases that rate 2 percent annually (a lower annual increase than utilities) for seven years. At the end of the seventh year, the recipient buys the solar array at 3 percent of the cost of the initial unit. This structure allows the recipient of the panels to switch to solar at no short-term cost and achieve energy savings over the long run. Providing additional social impact, the business hires and trains OZ residents to conduct the installations.

By using OZs within this structure, the fund makes an extra 3 percent from the 15 or 10 percent step-up in basis. It passes these savings through to consumers by shortening the period over which they fully pay off the system to 7 years (absent OZ incentives the consumer would have to make payments over 8 years). Additionally, the investors receive the benefit of the tax deferral on their capital gains.

Because of the need to take depreciation (which cannot be done through a QOF), the fund has a mixed-stream structure. The fund provides 50 percent of the investment, and a separate investment fund LLC (non-OZ) provides the other 50 percent into a business set up for installing solar panels.

Presently the fund is relying solely on the capital of a high-net-worth individual (who owns the fund, the LLC, and the business involved) and her children. This investor is realizing a 1 percent annual return on her investment and benefiting from the tax deferral. This return could be increased to 2–3 percent annually on future ventures now that the initial legal and accounting fees associated with structure have been incurred. In a state that offers solar renewable energy credits, the investor estimates annual returns could be up to 3–5 percent.

Particularly in a state that does not offer solar renewable energy credits, such as Virginia, solar panel installation may not attract typical OZ investors considering the competitive marketplace. However, such a structure could be an attractive vehicle for investors looking to use their money to promote a social cause. In this case, OZs provided the investor with the tax deferral benefit and allowed for increased social benefits via the step-up in basis.

7. Even for Real Estate, Exit Strategies at Year 10 Raise Challenges for Project Sponsors

Given that their investments are illiquid, most OZ investors want to cash out at the earliest possible opportunity while maximizing the tax benefits—in other words, at year 10. While this investment time horizon is long from the investor perspective, most mission-driven practitioners are seeking to hold the asset for still longer. Thus, project sponsors must plan an exit strategy for their investors—in many cases, they report, at the expense of the social impact components of their projects.

Many project sponsors are planning to buy out the OZ investors at year 10. Some of our interviewees report having negotiated an option to buy at a set price where they pay the return of capital, plus a multiplier (e.g., one and a half the value of the original investment). Working in rapidly appreciating neighborhoods is an additional concern for sponsors who intend to buy out their OZ investors, and who may have to face increased costs. Further, according to some of our interviewees, the OZ designation began to accelerate the appreciation of land in some tracts. For example, one city official in the Midwest was worried about how the OZ designation has intensified the already high property tax burden in some areas of the city because land values have increased. This places a large financial obligation on the project sponsor. The sponsor is looking into several strategies to sustain the project, such as refinancing the project at year 10, selling a portion of the project (e.g., some real estate units), banking cash flows, or combining all these strategies. A university we spoke with hopes that it will be able to refinance the equity investments using the HUD 223(f) program.

Not everybody intends to maintain control over their asset, or sustain its affordability. Some interviewees acknowledged that they planned to sell the asset in its entirety at year 10. Though not ideal, some OZ practitioners believe that this strategy is preferable to no project at all. As one nonprofit housing developer put it, “Finding a long-term strategy that maintains affordability is very complicated, but we know that having the property affordable for 10 years is still better than having the property sit for an unknown number of years before we get the necessary funding to get this project [multifamily housing] rolling.” Similarly, a sponsor seeking to build a food bank in South Carolina was hoping OZ investors would provide equity for what amounted to a real estate speculation play, with a sale of the property in year 10 and all the investor return provided by real estate appreciation. This latter strategy depends on expectations of rapid neighborhood price appreciation to attract investment. One affordable housing developer working in the Midwest market shared his satisfaction with the way the OZ designation had increased the value of some of his properties located in Zones.

It's going to involve state government in terms of thinking of public-private partnerships where they come in with some level of investment... or it could be how do you work with philanthropy that's in that area to begin to engage in a way that helps de-risk for that investor base as well. –CDFI QOF manager

8. To Drive Impact, OZs Often Need to Be Paired with Other Subsidy Sources

Sponsors are struggling to find equity support for their social impact projects; even when they can raise OZ capital, they often need to pair it with other subsidies or program benefits. One interviewee put it succinctly: “The more socially impactful the project, the more the need for subsidy [beyond OZ incentives].” Several of our interviewees are using (or planning to use) OZ incentives in conjunction with programs like NMTC, LIHTC, CDBG, HTC, the Section 108 Loan Guarantee Program, the Solar Investment Tax Credit, the SBA 504 loan guarantee, the Modified Accelerated Cost Recovery System, HUD 221(d)(4) loans,³⁴ and an array of state or local grants and city tax abatements. For them, OZ incentives are an “additional tool” to help fill out the capital stack, as one informant put it. However, combining OZ incentives with a number of other commonly used subsidies can present challenges.

For NMTC projects, our interviewees explained that most NMTC investors were separate from OZs investors in the capital stack, and that they were eager to understand how these two programs can be leveraged in the same investment (e.g., the same investor receiving the tax credits of the NMTC and the tax deferral and liability reduction of OZs for one transaction). One challenge to doing this, they report, is that most NMTC Community Development Entities want to make only debt investments, not equity investments. On the opposite side, practitioners report that the LIHTC and OZs can only be used together if they are leveraged by the same investor, to avoid timeline mismatches (the LIHTC compliance period is 15 years, and OZ investors maximize their benefits when pulling out immediately at year 10). One of the most challenging aspects of combining these programs is that the LIHTC and NMTC programs seek to fund projects that are not necessarily poised to generate significant nontax returns, while OZ incentives are most valuable when the project generates a substantial IRR.

For those working in the solar energy field, finding an investor that can leverage the OZ tax benefits together with the Solar Investment Tax Credit or Modified Accelerated Cost Recovery System has proven arduous. Since the OZ incentives can only be used by investors who have unrealized capital gains, and the Solar Investment Tax Credit and Modified Accelerated Cost Recovery System by those

with passive incomes, the pool of potential investors that can twin these programs is very shallow. Overall, the need for additional subsidies to deliver impact complicates the landscape for equitable development at scale through OZs. “The only way to create really deep impact is by twinning incentives, but that doesn’t work with large developers. They can’t afford to learn the intricacies of NMTC or LIHTC. You need to make your tools very accessible and predictable,” one fund manager explained.

You can only take advantage of the Investment Tax Credit and accelerated depreciation with passive income, whereas the OZ is only with capital gains... That’s a unicorn.

—OZ project sponsor

A CLOSER LOOK: Layering Community Development Programs

MetroHealth, Cleveland, Ohio

MetroHealth, the public health system in Cleveland, Ohio, is focused on creating an impact beyond medical care. Part of its mission is to address social determinants of health in the community. MetroHealth has identified the link between health and housing as a primary inflection point. Situated in the Clark-Fulton neighborhood, MetroHealth decided to begin in its own backyard by developing three mixed-use buildings that combine



Image credit: RDL Architects.

housing with street-level commercial property. The first building would contain up to 72 units of affordable housing, the second building would be workforce units for health system interns and residents, and the final building would be workforce housing. These two workforce buildings will contain up to 190 units. Targeted commercial tenants include a grocery store, economic development center, police station, and community college access center. The site also intends to include day care services, financial literacy training, and first-time homebuyer education.

MetroHealth envisioned and began work on this project before the introduction of OZs. However, OZs will play a necessary role in the capital stack—though they are seen as one tool of many that the health system has been assembling to bring this project to fruition.

The affordable housing building is structured without OZ financing as a LIHTC deal. MetroHealth has applied for a \$1 million tax credit award from the Ohio Housing Finance Agency’s pilot \$3 million incentive pool for LIHTC projects within the city of Cleveland. The city is also providing subordinate financing to support this development. The two workforce housing projects will use NMTCs and OZs financing as components of the capital stack, in addition to commercial debt financing. The combination of NMTC and OZs was cited as a major factor allowing the two workforce housing projects to pencil out from the developer’s perspective.

9. The Need for OZ Financing in OZ Projects Is Mixed

Interviewees gave mixed responses when we asked how critical a role OZs incentives played in the financing of their project. Only a few suggested their project could not have proceeded without OZ incentives:

- One developer reported, “We had exhausted state and county incentives. Had they had more money, we would’ve taken it from them because it’s cheaper. The project would’ve died but for the OZs investment.” This developer qualified their approach to using OZs incentives: “Are we putting anything under contract today, counting on OZs money if we don’t already know where it is coming from? No. Are we looking for OZs money on deals we already have under contract as an extra cushion? Yes... Never start a deal counting on OZs money. It is that last gap filler.”
- Another developer felt that “we probably could have done the deal at a market rate, but the affordable component, keeping rents at the workforce housing level—we couldn’t do that without the OZs incentives.”
- A QOF manager felt that “investors simply would not be there at all for our deal, without the OZs incentives”—but this fund manager had yet to raise financing when we spoke with them.

Having OZs equity allowed us to create a much safer project to handle the stresses of this health crisis. We can withstand the time delay that coronavirus is causing for our tenants to move in and start operations. —QOF manager and real estate developer

The largest group of interviewees we spoke with reported a role for OZ incentives that was somewhere in the middle ground—useful, but not critical, for financing their deal.

- A vertical farming operation that relocated to an OZ reported that “[Locating in] an OZ was a big factor for us—a key factor. But not as defining as having a pad-ready site.”
- A solar developer commented that the OZ program “adds a little sliver [of return]. It’s not this huge, wonderful thing.” Another solar developer agreed that “You could do this project without OZs incentives... but [they] help.”
- Several interviewees felt that the OZs incentives were mainly useful for raising the visibility of a deal with prospective investors. As one developer put it, “What [OZs] do is it shines a spotlight [on your deal]. It’s a buzzword, a catchy thing these days. Opportunity Zones are a great fad.”
- Some sponsors felt that the importance of OZ incentives varied from investor to investor. “For three-fifths of investors [in our project], OZs is important, for two-fifths it is secondary, but for all of them it was helpful.”

Still, others confidently expressed that they would have completed the financing and implementation of their projects had the OZs program not existed. Most of these practitioners characterized the tax incentives provided by OZs as an “enhancer” for the terms of their deals that could translate into a modest increase in the IRR. These deals might still marginally benefit from OZs incentives—by having deals close faster, for example—but the incentive was clearly not necessary to make them happen.

- One developer said: “Every deal that I do with OZs, I can do without. I underwrite and create a strategy without OZs but I turn around and I say... you might get 15 percent here but now you’re going to get 17–18 percent. What I do is use OZs... as a tool to sweeten the terms of the deal.”
- In many of our interviews, practitioners reported that they had already committed to their projects before accessing OZs incentives—in some cases, even before the census tracts were designated as a Zone. As one reported: “We thought about this project not because of OZs, but because there was the need and demand for it. We’ve been assembling land for two and a half years...Without the OZs incentives we still would have figured out a way to do this, it just makes it easier to facilitate.”
- In three cases where we interviewed project sponsors, financing for the project had been finally structured before it became known that the project was in a Zone and eligible for incentives.

OZs were used in place of other equity capital that had been pledged. “We honestly predated the OZs program,” said one developer.

Even when improving returns for investors, most project sponsors report that OZs were not critical for filling a financing gap or increasing the social impact goals of their venture. Because of the program’s timeline, practitioners reported that it would be difficult to use the full extent of the incentive for a project that was not already on the drawing board. As a sponsor of a QOF noted, “Given just the development timeline that projects take, unless they were shovel ready or in the process of being developed, many won’t be able to take full advantage of OZs.”

The Opportunity Zones program is kind of like salt—it enhances a deal that is starting to make sense and helps it go forward. It doesn’t fundamentally change the structure of a meal, though. –Real estate developer

A CLOSER LOOK: Financing a Project Entirely with OZ Equity

Chatham Facility, Chicago, Illinois

The nonprofit Chicago Cook Workforce Partnership (CCWP) provides services and programs that enable youth and adults to develop skills and knowledge to meet the labor needs of Cook County’s employers. CCWP will open its new Chatham Workforce Training Center in the South Side of Chicago in 2020, where it will house part of its administrative operations and provide workforce development trainings and workshops.

The new center is being built on a two-story 10,440-square-foot office building in the Chatham neighborhood. The project was initiated by IFF, a CDFI working primarily in the midwest, with a \$250,000 grant support from a large bank.



Image credit: GMA Construction Group.

Six months after commencing the development, and looking for a stable permanent owner for the property, IFF sold it to a local family office, which will rent the space in its entirety to CCWP. Initially, the family office explored the possibility of supporting the project by donating to IFF the necessary

capital for the build-out. However, the OZs legislation passed while the parties were negotiating, and they learned the site was located in a Zone. The family office created its own QOF in 2019, bought the property for roughly \$2 million, and spent an additional \$1 million to finish the construction. The \$3 million total investment was made entirely with OZ equity from that one family office.

Implications and Recommendations

OZ proponents and government officials have described the goals of the incentive as being to spur economic development, promote business growth, create quality jobs,³⁵ and in so doing to “help address the persistent poverty and uneven recovery that left too many American communities behind.”³⁶

According to the original concept paper proposing the incentive, OZs are intended to address a panoply of social ills related to living in areas with high unemployment and job loss, including increased illness and mortality, lower achievement outcomes for children, the breakup of families, and significant lifetime earnings disparities between those who grow up in poor versus wealthy neighborhoods (Bernstein and Hassett 2015).

Unfortunately, based on our interviews of people involved in OZ projects and attempted projects to date, the structure of the incentive appears to be least workable for the projects that could have the highest impacts around these issues. When mission-oriented OZ projects have been successful, it is typically only after substantial wrangling: searching for partners who will prioritize mission over profits, pairing OZ finance with other subsidy sources, and making concessions on issues like 10-year exits. As we have learned, the program can be used to finance projects that yield substantial community benefit, but it provides neither the depth of subsidy nor the use restrictions to incentivize the private market to prioritize such projects.

OZs disadvantage high-impact projects in four crucial ways.

1. Instead of rewarding impact investors who are willing to support projects with large social impacts, the capital gains exemption on OZ projects is structured to provide the largest financial benefits to the projects that provide the highest returns. Luxury housing in appreciating neighborhoods therefore may receive much larger public support than, say, affordable housing projects.
2. Because the incentive is limited to capital gains, the program does little to democratize community investing or ownership. Few people have sufficient capital gains to make OZ investments, thus creating a narrow pool of investors to which projects sponsors can appeal. In

particular, the OZ incentive design overlooks the possibility of supporting investments from low-income community stakeholders who do not have capital gains. This pool is much larger than many policymakers might imagine. For example, deposits by low- and moderate-income households in Community Development Credit Unions, which provide affordable debt to small businesses, homes, and families in low-income communities, total over \$112 billion—more investment than may occur through OZs.³⁷ The OZ incentive design also does not support or incentivize investment from other funds that may have a strong natural disposition to consider community investments, such as pension funds and foundation endowments.

3. The 10-year time horizon of most OZ equity investments is not long enough for long-term community ownership of such assets as affordable housing, health care centers, or schools, causing equitable development project sponsors to scramble to put together refinancing plans that may not work in a future interest rate or real estate market environment. Conversely, the 10-year time horizon is too long, too illiquid, and too fixed to make the incentive useable for non-real estate business investments.
4. The financing that the OZ incentives are designed to promote is poorly suited for most equitable development uses. By and large, OZs are effectively promoting market-rate private equity investment in real estate. But truly disinvested Zones with complex, long-standing challenges need investments in small businesses that will create quality jobs, as well as community resources such as affordable housing, schools, child care centers, and health care. Market-rate private equity for real estate is a poor vehicle to deliver these kinds of investments. It is unlikely, in our view, that OZ financing alone can unlock the small business growth or the development of community institutions and amenities that is needed to promote equitable growth.

Mission Actor Opportunity Zone Use Strategies

Despite multiple challenges they face, mission-oriented actors have developed coping strategies to be able to use OZ incentives, particularly through partnership with philanthropy and incentives offered by local and state governments. Across our interviews, we spoke with project sponsors that have pursued a series of strategies to compete for OZ financing despite being at a market disadvantage. Strategies to use OZs for projects that promote equitable development include the following:

- **Combining multiple subsidies:** Most of the successful high-impact projects have pursued OZs as one source of subsidy among many, pairing them with LIHTC, NMTC, local tax abatements, and other federal, state, or local government programs and incentives).
- **Partnering with anchor institutions:** Many sponsors have sought support from anchor institutions, such as hospitals, higher education institutions, faith-based organizations, or municipal or other local government enterprises. Even if they cannot invest in the project, these institutions may connect sponsors with the investment circles that can.
- **Developing a two-round financing structure:** Project sponsors hoping to control community assets for the long term are banking on raising other capital to buy out the OZ investor after year 10. Obviously, it remains to be seen whether they will be successful in doing so.

Philanthropies can also effectively further work to support high-impact OZ projects. Effective strategies include the following:

- **Pooling resources:** A national example is the Kresge Foundation and the Rockefeller Foundation's partnership in resources, grants, and guarantees in support of investments that align with specific criteria.³⁸
- **Junior equity:** Where philanthropy attempts to lower investment risk via junior equity positions or other strategies, their efforts can be targeted toward high-impact projects.
- **Using equitable development frameworks in grantmaking:** For instance, philanthropic resources could be restricted to supporting projects that score highly on Urban's Opportunity Zone Impact Assessment Tool³⁹ and funds in compliance with the US Impact Investing Alliance and Beek Center's Opportunity Zones Reporting Framework.⁴⁰ Particularly for high-impact projects looking to leverage funds from market-rate OZ investors, philanthropic dollars could enable a project's return to be high enough to be marketable to Opportunity Funds. This might also mean supporting community catalysts for equitable investment, including the work of empowering, organizing, educating, and matchmaking.

States and local governments, while unable to fully tip the balance, have options at their disposal to put their weight on the scale for higher-impact OZ projects (see Theodos, Evans, and Meixell 2019). States and cities can consider encouraging or aiding mission-aligned projects in ways similar to the following:

- **State benefits for QOFs:** States can create added benefits for QOFs that meet specific impact investing standards.⁴¹ Funds might receive the state capital gains tax benefits, state tax credits,

or other incentives for these investments. In addition to supporting equitable development goals, states should require funds to track and report OZ investment activity.⁴²

- **State marketplaces:** To lessen search costs and connect beneficial projects with willing investors, Washington, DC, and several states (including Maryland, New Jersey, Virginia, and West Virginia) have begun maintaining central databases of aspiring fund managers and interested investors. The Opportunity Exchange serves this role across several states.
- **OZ coordinators:** A handful of cities (including Atlanta, Baltimore, Cleveland, DC, Kansas City, and Norfolk) and states (including Alabama, Colorado, and Virginia) have OZ coordinators that serve as project-investor matchmakers.
- **Tax abatements and other incentives for equitable development projects:** Many localities have offered property tax abatements or other incentives to projects that provide social benefit for residents. These and other local incentives can be an important part of the capital stack, making high-impact projects financially viable.

Broader Changes

Greater structural changes are necessary if the types of OZ projects that generate substantial social impact and community benefit for low- and moderate-income residents are to turn from the exceptions into the rule. These changes go well beyond the calls for better reporting—important as the matter is. (See Theodos [2019] for more on reporting needs.)

More comprehensive approaches to prioritize the highest impact projects could come through federal legislative or administrative action. We focus here on the fundamental changes needed for the program to fully support equitable development, but other, more incremental changes would also be valuable. Those changes include, for example, removing all contiguous tracts as well as low-income tracts that no longer qualify as such.⁴³

More sweeping statutory changes could redesign OZ incentives so they much more effectively target limited government resources toward equitable development outcomes. The broad principles that should guide reshaping of the OZ incentives include the following.

- **Better support investments in small businesses.** The most egregious failing of OZs to date is that very little investment is going to small businesses, the exact group of investees that proponents had held out as standing the most to benefit. To correct this failing, one important solution is incentivizing investments in QOFs that could provide subordinated debt investment

(or hybrid debt/equity products such as royalty debt) to small businesses; pure equity is simply not an appropriate form of small business financing in many cases. Beyond that, policymakers should consider granting greater flexibility around certain program rules, such as deployment rules, to mission-driven funds that specialize in small business investing. Mission-driven practitioners need to be consulted as a part of this process. Further, OZs can be restricted to a more narrowly qualifying set of investments—for instance, real estate transactions only when the operating business is the owner-occupant

- **Size the incentive based on the impact.** Rather than providing the largest incentives to the most profitable projects, the incentive should instead depend on projected social impacts. In turn, by targeting incentives toward investments with the greatest impacts, these investments could be more deeply subsidized while more efficiently using total federal tax expenditures. To provide one example, OZ tax incentives could be based on the number of quality jobs created by the investment—thus aligning the incentive with a goal at the heart of the legislation’s original intent. Given that US businesses already regularly report employment and wages to both the state and federal governments, the data exist to make structuring such a system possible. Other alternatives could include tweaking the incentives based on the equitable development characteristics present in a project, such as limiting the incentives to projects where a positive social impact is deemed likely.
- **Broaden who can invest.** There is no particularly good reason to limit incentives for community investing to taxpayers who have prior capital gains. Doing so freezes out most stakeholders in low-income communities from investing in their own revitalization. A refundable tax credit, rather than a capital gains exclusion, could open up opportunities for these investors. Other actors such as foundation endowments and pension funds have substantial resources (and most likely a greater proclivity to consider community investing than many capital gains holders) if an incentive can be structured to engage them.
- **Support mission-driven funds that are accountable to the community.** The OZ program should be changed to require a rigorous certification process for QOFs rather than allowing funds to self-certify. This will help support mission actors rather than other OZ activity. Additionally, reforms should be made to support CDFIs, which have a long track record of making substantial investments in low-income communities. CDFIs are accustomed to taking on higher risks than conventional investors, as well as to working with the kind of investees who have been struggling to access OZ capital, such as small businesses and less sophisticated developers. CDFIs have successfully mitigated these risks by providing hands-on technical assistance to

their investees. A major constraint to growing the impact of CDFIs has been the lack of equity to capitalize them—an issue the industry is actively seeking to address. A redesigned OZ incentive could encourage equity investments in CDFIs who set up QOFs. In combination with opening up OZ incentives to new forms of investment, such as subordinated debt or debt-with-royalty products, this policy change would greatly expand the catalytic role that CDFIs are already playing in distressed communities, and help realize the promise of OZs for the many project sponsors who have struggled to access capital to date.

As we write this report, Wall Street's extended bull run has ended, COVID-19 has the world at a standstill, and financing is volatile. People are beginning to emerge from their homes and the economy will recognize these gains. Predicting the future—always a difficult endeavor—feels all the more challenging now. However, in their present form, based on the field to date, it appears that OZs are neither on a trajectory to democratize access to capital nor will they, at scale, incentivize mission-oriented projects that align with community goals and priorities. An impressive mission-aligned OZ ecosystem is developing, and project sponsors are making impressive efforts to promote more equitable development. But this ecosystem and these efforts are insufficient in a marketplace incentivized to generate greater investor reward for more conventional projects. Philanthropic and local and state actors have options to partially reorient OZs to enhance community outcomes, but only the federal government can correct the structural barriers that discourage and prevent mission-aligned actors from using OZs to their full potential.

As we grapple with the twin public health and economic threats the current moment poses, and longstanding issues with police violence, the very place-based iniquities that compelled the creation of OZs, are at risk of widening further. COVID-19 has underscored troubling disparities in neighborhood access to vital services and amenities from health care facilities to grocery stores. Looking back to our last economic crisis, the Great Recession substantially exacerbated wealth disparities between White families and Black and Latinx families. Average family wealth fell across all groups between 2007 and 2010, but with vast differences by race and ethnicity: 40 percent among Latinx families, 31 percent among Black families, and only 11 percent among White families (McKernan and Ratcliff 2013). We do not yet know how the COVID-19 recession will play out, but we should be prepared to see disparities.

As our attention turns to recovery, OZs likely have a role to play. That role, as our early findings indicate, could be solely to compel new economic activity in communities. But at this critical juncture, its role could be altered to create truly equitable development, building wealth for low- and moderate-income residents while meeting community needs. As federal policymakers consider extension and revisions to the OZ incentive in a post-COVID context, this potential should not be missed.

Appendix. Opportunity Zones Overview

Part of the Tax Cuts and Jobs Act of 2017, the Opportunity Zones incentive offers capital gains tax relief for investments in economically distressed areas.⁴⁴ OZs aim to address a failure in capital markets, in which disinvested communities have lacked access to capital to fund investable projects (Theodos 2019). Individuals and corporations who have recently sold an asset for a capital gain can defer and reduce their taxes by investing the gains in Qualified Opportunity Funds, or QOFs. The QOFs must take those funds and provide equity investments to qualifying businesses and real estate projects in designated OZs. Across the country, 8,766 census tracts have been designated as Opportunity Zones.

The OZ incentive offers three distinct tax benefits for investors:

1. **Deferral of capital gains taxes:** Investors reinvesting capital gains into a QOF can defer taxes on those capital gains until December 31, 2026 (or the date of sale of the new qualifying investment, if the sale happens sooner).
2. **Reduction in the amount of the capital gains tax:** Investors can reduce the amount of capital gains tax by 10 percent if they hold the investment in the QOF for at least five years. At seven years, the capital gains tax reduction increases to 15 percent.
3. **Exemption from capital gains tax on capital gains generated by the QOF:** If investors keep their funds in the QOF for at least 10 years, then they pay no tax on any capital gains from the new investment. The value of this part of the incentive is much larger for investments that yield larger pretax returns. Observers believe that as a result, most investors will want to channel funds into investments that appreciate rapidly at the expense of those that do not (Tansey and Swack 2019).

Notes

- ¹ “Connect with Projects from Across Our Network,” The Opportunity Exchange, accessed February 24, 2020, <https://www.theopportunityexchange.com/browse/>.
- ² “EIG Opportunity Zones Activity Map,” Economic Innovation Group, accessed November 20, 2019, <https://eig.org/oz-activity-map>.
- ³ Much has been made of whether to call OZs a “program” or an “incentive,” in ways that strike us as having more to do with ideology than the underlying meaning of those terms. In our view, much in the OZ statute and implementation is programmatic, and OZs are an incentive. As such, we use the terms interchangeably.
- ⁴ Michael Novogradac, “Novogradac Opportunity Funds List Surpasses \$10 Billion in Investment,” Novogradac, April 29, 2020, <https://www.novoco.com/notes-from-novogradac/novogradac-opportunity-funds-list-surpasses-10-billion-investment>.
- ⁵ According to the IRS website, OZs are “designed to spur economic development and job creation in distressed communities” (“Opportunity Zones Frequently Asked Questions,” accessed April 21, 2020, <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions>).
- ⁶ For examples, see the published transcript of “The Promise of Opportunity Zones,” Senate Hearing 115-297 before the Joint Economic Committee, accessed April 21, 2020, <https://www.govinfo.gov/content/pkg/CHRG-115shrg30384/html/CHRG-115shrg30384.htm>.
- ⁷ For investments held for at least 10 years, investors pay no taxes on any capital gains produced through their investment in Opportunity Funds (“What Are Opportunity Zones and How Do They Work?,” Urban-Brookings Tax Policy Center, accessed April 26, 2020, <https://www.taxpolicycenter.org/briefing-book/what-are-opportunity-zones-and-how-do-they-work>).
- ⁸ Adam Looney, “Will Opportunity Zones Help Distressed Residents or Be a Tax Cut for Gentrification?” *Up Front* (blog), Brookings Institution, February 26, 2018, <https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/>.
- ⁹ See, for example, Jesse Drucker and Eric Lipton, “How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich,” *New York Times*, August 31, 2019; Noah Buhayar and Caleb Melby, “Real Estate Investors See Riches in a Tax Break Meant to Help the Poor,” *Bloomberg*, January 15, 2019; Justin Elliott et al., “A Trump Tax Break to Help the Poor Went to a Rich GOP Donor’s Superyacht Marina,” *ProPublica*, November 14, 2019; Alex Nitkin, “How a \$2 Billion Redevelopment Site in Chicago Landed in a Federal Opportunity Zone,” *The Real Deal Chicago Real Estate News*, May 1, 2019; and Christopher Hong and Nate Monroe, “Stadium, Sports District Could Benefit from Program Intended for Poor Neighborhoods,” *Florida Times Union*, December 14, 2018.
- ¹⁰ Anthony Pipa, “Maximizing the Impact of New Opportunity Zones Requires Transparency and Citizen Engagement,” *Up Front* (blog), Brookings Institution, April 16, 2018, <https://www.brookings.edu/blog/up-front/2018/04/16/maximizing-the-impact-of-new-opportunity-zones-requires-transparency-and-citizen-engagement/>.
- ¹¹ “Connect with Projects from Across Our Network,” <https://www.theopportunityexchange.com/browse/>.
- ¹² “EIG Opportunity Zones Activity Map,” <https://eig.org/oz-activity-map>.
- ¹³ “Treasury Releases Proposed Regulations on Opportunity Zones Designed to Incentivize Investment in American Communities,” US Department of the Treasury press release, October 19, 2018, <https://home.treasury.gov/news/press-releases/sm530>.

- ¹⁴ Kurt Badenhausen, “The NBA’s Unlikely Real Estate Mogul: Inside Luol Deng’s Towering \$125 Million Portfolio,” *Forbes*, June 21, 2019, <https://www.forbes.com/sites/kurtbadenhausen/2019/06/21/the-nbas-unlikeliest-real-estate-mogul-luol-dengs-125-million-portfolio-is-a-new-playbook-for-monetizing-fame/#292577291db9>.
- ¹⁵ See, for example, “Navigating the Opportunity Zones,” a playbook put together by LISC to “lay out best practices for the range of Opportunity Zone actors” (accessed April 26, 2020, <https://www.lisc.org/opportunity-zones/community-partners-playbook/>).
- ¹⁶ “U.S. Economic Development Prioritizes Applications for Projects Located In Opportunity Zones,” US Economic Development Administration, press release, June 12, 2019, <https://www.eda.gov/news/press-releases/2019/06/12/opportunity-zones.htm>.
- ¹⁷ “FHA Offers Incentives For Property Owners Who Invest In Opportunity Zones,” US Department of Housing and Urban Development, press release 19-058, May 9, 2019, https://www.hud.gov/press/press_releases_media_advisories/HUD_No_19_058
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- ¹⁹ Anne Kniggendorf, “Creating a Model That Sets the Curve for Opportunity Zone Investment,” Ewing Marion Kauffman Foundation, August 1, 2019, <https://www.kauffman.org/currents/creating-a-model-that-sets-the-curve-for-opportunity-zone-investment/>.
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- ²⁴ “New Incubation Program Opens to Help Social Impact Orgs Ready for Opportunity Zone Funds,” The Kresge Foundation, news release, November 29, 2018, <https://kresge.org/news/new-incubation-program-opens-help-social-impact-orgs-ready-opportunity-zone-funds>.
- ²⁵ “The Rockefeller Foundation and Smart Growth America Launch National Opportunity Zones Academy,” Rockefeller Foundation, news release, September 17, 2019, <https://www.rockefellerfoundation.org/about-us/news-media/rockefeller-foundation-smart-growth-america-launch-national-opportunity-zones-academy/>.
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- ²⁷ “CDBG Entitlement Program Eligibility Requirement,” HUD Exchange, accessed April 26, 2020, <https://www.hudexchange.info/programs/cdbg-entitlement/cdbg-entitlement-program-eligibility-requirements/>.
- ²⁸ Authors’ calculation based on IRS Statistics of Income from Tax Year 2016, Table 1.4.

- ²⁹ Author calculations using 2014–18 US Census Bureau American Community Survey. Data accessed through the National Historic Geographic Information System’s online portal (IPUMS NHGIS, University of Minnesota), www.nhgis.org.
- ³⁰ “Home Rule, as it sounds, gives local governments governing authority to make a wide range of legislative decisions that have not been addressed by the state. By contrast, the Dillon Rule creates a framework where local governments can only legislate what the state government has decreed” (Russell and Bostrom 2016, 1).
- ³¹ “T18-0231 - Distribution of Long-Term Capital Gains and Qualified Dividends by Expanded Cash Income Percentile, 2018,” Tax Policy Center, accessed April 26, 2020.
- ³² IRS, “Opportunity Zones Frequently Asked Questions.”
- ³³ Novogradac, “Novogradac Opportunity Funds List Surpasses \$10 Billion in Investment.”
- ³⁴ The FHA 221(d)(4) loan, guaranteed by HUD is the multifamily industry’s highest-leverage, lowest-cost, non-recourse, fixed-rate loan available in the business. 221(d)(4) loans are fixed and fully amortizing for 40 years, not including the up-to-three-years, interest-only fixed-rate during construction. In summary, the loan is fixed for up to 43 years and fully amortizing for 40 (“HUD 221(d)(4) Non-Recourse, Ground-up Development and Substantial Rehabilitation Multifamily Financing,” HUD Loans, accessed April 26, 2020, <https://www.hud.loans/fha-221d4>).
- ³⁵ IRS, “Opportunity Zones Frequently Asked Questions.” Also see quotes from Opportunity Zones proponents on the Economic Innovation Group’s website, accessed April 23, 2020, <https://eig.org/opportunityzones>.
- ³⁶ “History of Opportunity Zones,” Economic Innovation Group, accessed April 26, 2020, <https://eig.org/opportunityzones/history>.
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- ³⁹ The tool is available at <https://www.urban.org/oztool>.
- ⁴⁰ The framework is available at <https://ozframework.org/>.
- ⁴¹ For example, “AL Impact Investment OZ Incentives Summary,” Opportunity Alabama, accessed April 26, 2020.
- ⁴² For more on what metrics should be collected see Brett Theodos and Brady Meixell, “Public Comment on U.S. Treasury’s Request for Information on Data Collection and Tracking for Qualified Opportunity Zones,” May 30, 2019.
- ⁴³ Contiguous zones did not meet the low-income community threshold but were eligible because they bordered low-income communities. Zones that, with updates to the Census Bureau’s American Community Survey, no longer qualify as low-income communities could also lose their status.
- ⁴⁴ Final regulations for the program were promulgated on and are available at 26 CFR Part 1, or via “Investing in Qualified Opportunity Funds,” Internal Revenue Service, accessed April 26, 2020, <https://www.irs.gov/pub/irs-drop/td-9889.pdf>.

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About the Authors

Brett Theodos is a senior fellow in the Metropolitan Housing and Communities Policy Center at the Urban Institute, where he directs the Community Economic Development Hub.

Eric Hangen is the principal of I Squared Community Development Consulting, LLC, which provides strategic planning, market research, program evaluation, and financial modeling consulting to nonprofit clients nationwide. In his role as a senior research fellow at the Carsey School of Public Policy, he researches trends in impact investing and opportunity finance in the United States.

Jorge González is a research analyst in the Metropolitan Housing and Communities Policy Center. His research focuses on how the built environment and access to capital contribute to the economic development of neighborhoods and their communities.

Brady Meixell is a research analyst in the Metropolitan Housing and Communities Policy Center. His work focuses on community and economic development, racial and economic disparities, and place-based interventions to address poverty and related issues.

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