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Leveraging Philanthropic Resources at the Nexus of Opportunity Zones and Affordable Housing

A Report Conducted for the Chan Zuckerberg Initiative

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Contents

This is an abbreviated version of a full report the author completed for the Chan Zuckerberg Initiative. The author also conducted this study as part of the program of professional education at the Goldman School of Public Policy, University of California at Berkeley. The judgments and conclusions are solely those of the author, and are not necessarily endorsed by the Chan Zuckerberg Initiative, Goldman School of Public Policy, by the University of California or by any other agency.

Introduction

The adoption of the federal Tax Cuts and Jobs Act of 2017 (TCJA) introduced Opportunity Zones (OZs), which incentivize private investment in designated economically distressed communities. While there is potential for positive net benefit as a result of this incentive, there is also great risk of inducing further displacement, disenfranchisement, and reinforcement of historic inequities.

The OZs provision creates a private market for investors to exploit. It also creates an opportunity for cross-sector partnership and a role for philanthropies to leverage financial resources and technical capacity to further their strategies. City government, community development corporations, advocates, non-profits, foundations, and other key partners in cities and OZs across the country have already made significant progress toward answering some of these questions for their own communities. Some of these potential stakeholders have been slower to act - proactively or in response to the federal OZ designation.

Ultimately, the OZ incentive is distinct from programs that came before in its total lack of oversight or regulation. Instead, it is the private market that determines where federal resources are best utilized. The most lucrative OZ investments are those in markets on the upswing - those that are already gentrifying and vulnerable. The space for alignment between the production or preservation of affordable housing and OZs is very narrow. Deals at this nexus require a particular expertise and level of experience that few developers have. Regulatory requirements of the tool make preserving existing affordable housing impossible. OZs cannot fundamentally change the market; investors in this space continue to look for certainty and significant levels of return. Given these findings, what options remain for philanthropies interested in creating impact for communities impacted by OZs?

This report recommends that foundations take an approach that is not OZ-specific, but rather considers the broader question of how capital is leveraged to advance community wealth in disinvested, low-income communities. While disengaging from OZs is another path philanthropy could choose to take, the potential impact of the OZ incentive for communities is too great to ignore. Philanthropy cannot afford to continue to sit on the sideline with regard to OZs.

Another critical consideration shapes the findings herein. The recent unprecedented impacts of Covid-19 to financial markets, housing policy, and local communities have ramifications for the recommendations included here. Foundations must now work in a very different context than they did just a few months ago. In recent years, philanthropy grew accustomed to operating in an environment of prosperity. Now the field must adapt to the realities of deploying funds and strategies in a recession. These recent developments increase the level of uncertainty in what was already a nascent market. Foundations considering whether to play a role in the OZs space must understand and weigh the ramifications of this increased level of risk.

What Are Opportunity Zones?

The December 22, 2017 adoption of the TCJA introduced OZs, a tax advantaged designation which incentivizes investment in census tracts in economically distressed communities. The resulting 8,700 zones in all 50 states, Washington D.C. and five territories are Treasury certified and cover approximately 12 percent of the country.[1] The designation lasts for ten years, expiring on December 31, 2028. The Joint Committee on Taxation of the U.S. Congress estimates OZs will cost at least $1.6 billion in lost tax revenue over a ten year period.[2]

Taxpayers interested in taking advantage of the incentive have 180 days to invest previously realized capital gains into a Qualified Opportunity Fund (QOF) in order to be eligible for a number of tax benefits. QOFs are privately managed investment vehicles that must hold 90 percent of their assets in OZ properties or pay a penalty.[3] The legislation requires investments substantially improve an OZ property within 30 months to be eligible for the tax benefits.[4] The three OZ tax benefits are detailed below.

Types of Opportunity Zone Tax Benefits

1. **Temporary <u>Deferral</u> of Capital Gains**
   Capital gains income that is reinvested in a QOF is temporarily deferred from the investor's federal taxable income, and will not be taxed until the sooner of the date the investment is sold or December 31, 2026.

2. **<u>Reduction</u> in Tax Liability**
   Investments held for five years reduce taxable capital gains by 10 percent; those held for seven years reduce tax liability by 15 percent. Taxable gains could be reduced by 15 percent if invested by the end of 2019. The 10 percent reduction benefit remains available so long as capital gains are reinvested in a QOF by the end of 2021.

3. **Permanent <u>Exclusion</u> of Taxes on Future Gains**
   Investors who hold gains in QOFs for at least ten years may permanently exclude any appreciation in value of their shares from taxation. This benefit lasts through 2047.[5]

[1] Schleifer, Theodore. "The new hotness for tech billionaires? Do-gooder investments they can write off on their taxes." *Vox*, October 16, 2018.
https://www.vox.com/2018/10/16/17940120/opportunity-zones-sean-parker-silicon-valley-wealth-taxes
[2] Jacoby, Samantha. "Potential Flaws of Opportunity Zones Loom, as Do Risks of Large-Scale Tax Avoidance." Center on Budget and Policy Priorities. January 11, 2019.
https://www.cbpp.org/research/federal-tax/potential-flaws-of-opportunity-zones-loom-as-do-risks-of-large-scale-tax
[3] Economic Innovation Group. "The Tax Benefits of Investing in Opportunity Zones." January 2018.
https://eig.org/wp-content/uploads/2018/01/Tax-Benefits-of-Investing-in-Opportunity-Zones.pdf
[4] Stamper, Dustin and David Auclair. "Opportunity zone guidance offers flexibility for investors." Grant Thornton LLP. October 24, 2018.
https://www.grantthornton.com/library/alerts/tax/2018/Flash/opportunity-zone-guidance-offers-flexibility.aspx
[5] Jacoby, 2019.

The Opportunity Zone Ecosystem

The OZ ecosystem is now quite robust. The public accounting and tax consulting firm, Novogradac, maintains an Opportunity Funds Listing of self-reported information from QOF managers on equity raised. In May 2019, the Novogradac Opportunity Funds Listing reported $790 million in equity raised by 28 QOFs. The more stakeholders that dedicate time and resources to thinking about OZs, the greater the tool's potential to deliver true community impact. The OZ ecosystem includes fund managers; investors; community advocates; local, state, and federal government leaders; foundations; anchor institutions like community development corporations; and developers. It is important for foundations to look at the size and shape of the OZ ecosystem when developing strategy at the nexus of affordable housing and OZs.

Despite some similarities, the OZs legislation is distinct from prior programs in its lack of regulation or oversight. There is no single agency or authority that oversees OZs. Without intermediaries, local decision-making authority, or any cap on the possible benefit available, OZs create an opportunity for private markets to decide where federal resources can be best utilized.[6] The key drivers of the initiative are developers and private equity, rather than communities or local government. In essence, OZs have simultaneously "expanded the federal government's place-based policy and erased the federal government's role in executing it."[7] The legislation includes no requirements for reporting on transaction level information. As such, the OZs provision creates a private market whose impact it is challenging to monitor, measure, or predict.

Given the dearth of transaction level data, the complete universe of OZ deals can never be known. Whether projects can result in true community impact will be difficult to determine. This paper will grapple with this question in providing recommendations for leveraging philanthropic resources at the nexus of OZs and affordable housing. It is this tradeoff, however, that the field as a whole must confront: whether a tool with uncertain outcomes merits significant time and resources when measuring its impact at scale will be challenging at best.

Opportunity Zones & Affordable Housing

Some OZ communities have seen both public and philanthropic investment in the form of grants or debt to development projects. The OZ initiative, however, may be the first time in recent history that private capital flows into some OZ-designated communities. The tool is distinct in its provision of equity rather than debt or subsidy; flexibility of eligible investments; and built-in incentive to hold an investment long-term.[8]

The OZ incentive provides equity to projects. Financing affordable housing in the United States largely relies on grants, debt, and subsidy. The equity QOFs provide can be seen as a tool in the

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[6] Lowrey, Annie. "Fixing America's Forgotten Places." The Atlantic. July 24, 2018. https://www.theatlantic.com/ideas/archive/2018/07/how-do-we-help-this-place/565862/
[7] Ibid.
[8] Ross Baird, Bruce Katz, Jihae Lee, and Daniel Palmer. "Towards A New System of Community Wealth." Drexel's Nowak Metro Finance Lab, BluePrint Local and Accelerator for America. October 27, 2019.

developer's toolkit, providing more volume and impact as well as the potential for broadening the investor base.[9] However, OZs cannot fundamentally change the market. Investors and fund managers are looking for the same things they might in a non-OZ environment, namely shovel-ready projects that are de-risked and offer substantial returns. Despite appearing similar to other equity investment vehicles, OZ investment yields a lower rate of return in part due to the longer hold period.[10]

What Is Affordable Housing?

Affordable housing is a term used broadly and vaguely. In this report, affordable housing will refer to two categories of housing affordable (30 percent or less of monthly income) to a range of populations, from Extremely Low Income (30 percent or less of Area Median Income) to the Missing Middle (up to 120 percent AMI). This range is intentionally wide to capture local contexts and housing markets.

Deed-Restricted Affordable Housing

Deed-restricted affordable housing has a legal document recorded on the property for enforcing long-term affordability. Examples of deed-restricted affordable housing include units financed with LIHTC or federal, state, or local funding sources that include grants, debt, subsidy, or loans. This report considers whether there is alignment between OZs and affordable housing finance tools for the **production** of housing.

Naturally Occurring Affordable Housing

Naturally occurring affordable housing (NOAH) is housing that does not have any public subsidies or deed restriction preserving the affordability level. It is affordable housing provided by the private market. NOAH is affordable as a result of market conditions, but its affordability is not guaranteed by any legal means. This report considers whether OZs can play a role in the **preservation** of NOAH.

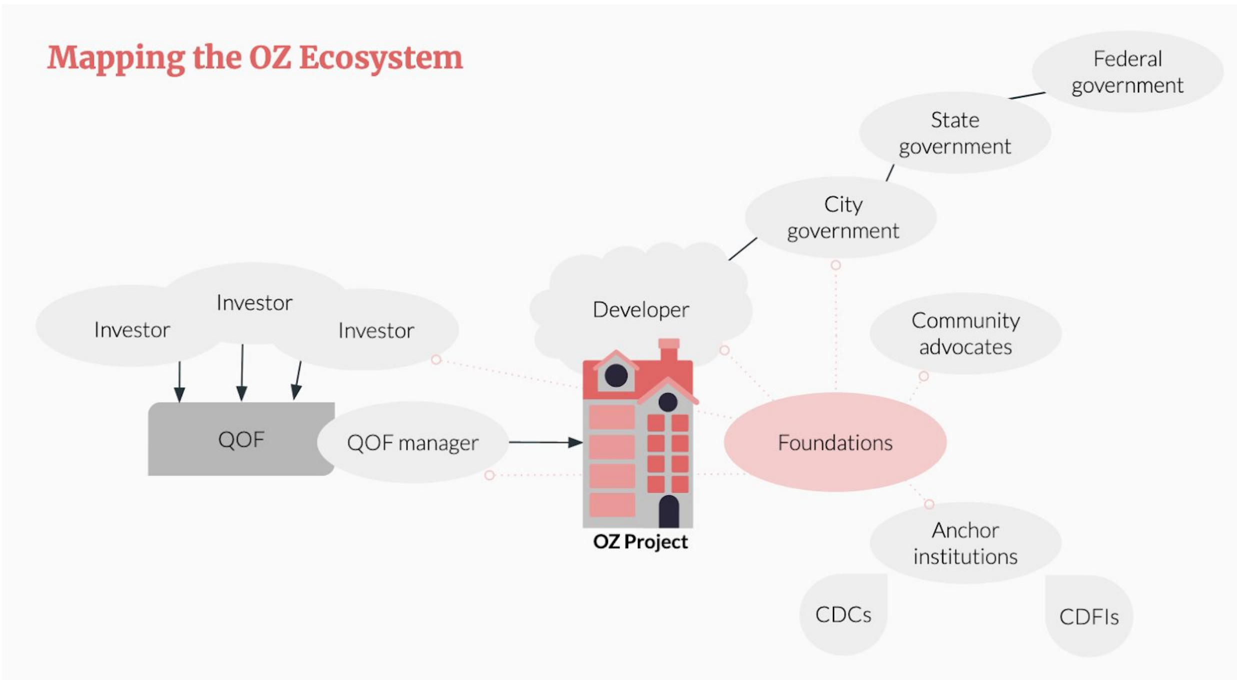
This means the space for alignment between OZs and traditional models of financing, preserving, and developing deeply targeted affordable housing is relatively narrow. Doing deals at this nexus requires an expertise and level of experience that few developers have. It requires stakeholders with technical knowledge as well as shared mission and vision. Importantly, it requires investors willing to accept lower rates of return. The substantial improvement requirement means a land trust or acquisition-rehabilitation deal is unlikely to work with the OZ incentive. Ultimately, the tool is misaligned with the preservation of NOAH or existing housing stock.

There are a few common factors that create a favorable environment for OZs to be utilized toward advancing housing policy goals. The strength of partnerships is key. See *Mapping the OZ*

[9] Serlin, Christine. "A New Tool for Housing." Affordable Housing Finance. January 10, 2019. https://www.housingfinance.com/finance/a-new-tool-for-housing_o

[10] McElhaney, Alicia. "Is Anyone Actually Investing in Opportunity Zone Funds?" Institutional Investor. May 23, 2019. https://www.institutionalinvestor.com/article/b1fjptxryzv07y/Is-Anyone-Actually-Investing-in-Opportunity-Zone-Funds

Ecosystem for an illustration of how potential stakeholders relate to the OZ project and to one another. Learnings from places like Birmingham, Alabama and Erie, Pennsylvania reveal the importance of having a lead institution - like a Community Development Corporation (CDC) - drive.



Ensuring all stakeholders have the necessary technical capacity to engage in project development is critical. Given the tax and timing complexities of the incentive, it is fund managers, investors, and developers who can drive project development. Communities able to identify a pipeline of shovel-ready projects - those that allow investors to invest capital gains immediately and meet the substantial improvement requirements - are also better-positioned to receive OZ investment that can further economic development goals. Keeping in mind these common factors of successful OZ partnerships and strategies can inform foundations seeking to create impact for communities.

Opportunity & Alignment: Philanthropy in Action

Foundations are uniquely positioned within this ecosystem because of their flexibility, relationships, and experience in community. Foundations have the ability to act as conveners; build capacity; to identify and fill gaps; to create connections where systems are disconnected. In communities across the country, foundations have taken on a range of approaches within this OZ ecosystem, providing insight into what is possible for other foundations. For any foundation, strategy must be informed by local context and stakeholders. Part of philanthropy's role must be to empower and give voice to organizations already doing the work of advancing opportunity for their communities.[11]

Considering the wider landscape of what others are doing in this space, it is important to develop an approach that is complementary to existing efforts rather than duplicative. At this stage in the evolution of the market, any strategy must consider the bigger question of how capital can be leveraged to build community wealth. Given the unprecedented effects of Covid-19, foundations must now adapt to the realities of serving communities and creating impact in a recession. Many of the communities philanthropy serves already faced significant affordable housing challenges during more prosperous times. What is different for foundations and communities given the realities and uncertainties of Covid-19? What can philanthropies do now to ensure recovery works for those communities already cut off from opportunity? How can an OZ strategy take all this into consideration?

Much has been written about philanthropy's response, or lack thereof, to OZs. As this paper outlines, OZs present an unprecedented opportunity for private investment in economically distressed communities where infusion of equity has long been needed. The tool also exacerbates historic inequities by spurring displacement and gentrification, widening already vast racial income and wealth disparities. Examples exist at both ends of this spectrum, and in the spaces in between. OZs cannot be categorized outright as "good" or "bad," but rather as a powerful tool whose potential is shaped by the strength of partnerships.

The OZ landscape is not without risk and uncertainties, but it is a private market that will continue to evolve whether or not philanthropies choose to act. While there remains uncertainty around measuring OZs long-term impact at scale, there exists enough data and evidence to say that OZs will impact communities philanthropy serves. The OZ market will continue to grow and adapt with or without philanthropy's involvement. Investors, fund managers, and developers with expertise and resources will continue to drive and shape the market. The fears of community members may become reality in already changing neighborhoods. Though the findings of this report cannot provide absolute certainty about what OZs will mean for residents of the 8,700 designated zones, learnings from stakeholders and communities across the country demonstrate that the incentive is being utilized in ways that help and harm economically distressed communities.

Philanthropy cannot afford to sit on the sidelines when it comes to OZs. Intentionally disengaging from any OZ-related programming or investments is not recommended. Given the uncertainties of this moment, philanthropies must now more than ever work to ensure that recovery works for those communities excluded from accessing opportunity. The OZs tool has the potential to be used to do just that, though realizing that potential will require unprecedented levels of collaboration and capacity. Foundations are uniquely positioned to serve as a convener, capacity builder, and bridge builder to maximize the potential of OZs as a tool for affordable housing.

[11] Seybert, Aaron, Lori Chatman, and Robert Bachmann. "Opportunity for Whom? A Call for Course Correction Based on Early Opportunity Zone Investments." Case Western University. February 2020.

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