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Reinvigorating Opportunity Zones to deliver housing and smart growth

The Trump-era Opportunity Zone tax incentive brought capital gains into community development in a new way. With Congress poised to consider extending the program in tax legislation moving through the reconciliation process, it is an opportune time to highlight high-impact reforms that could help the tool better deliver much-needed housing, especially in locations with good access to jobs and amenities.

The 2017 Tax Cuts and Jobs Act created the Opportunity Zones tax incentive (OZs), an economic development tool designed to catalyze investment and growth in designated distressed communities. The OZ incentive, which operates by providing a set of preferential tax treatments to entities that invest capital gains into qualifying investments in underinvested or otherwise distressed communities, has driven a new wave of investment into residential and commercial properties in many places. Materials prepared by the Joint Committee on Taxation found the joint value of OZ investments topped $84 billion in 2022. Novogradac, a leading accounting and consulting firm in the OZ space that tracks just a segment of OZ funds, found that nearly 200,000 homes had been built or were scheduled using OZ financing, while the Economic Innovation Group's recent working paper found that the OZ incentive led to an increase of over 300,000 new residential units in designated communities.

While the Opportunity Zone incentive has successfully brought new capital into a wide swath of the more than 8,700 designated opportunity zones, the intervening years since the incentive was put in place have seen significant economic changes that have reshaped the development landscape. The development community's attempts to use the tool have also revealed key shortcomings that require policy changes to address. Since the initial passage of OZs in 2017, the country's housing affordability and availability crisis has worsened, a global pandemic has reshaped the office and retail development environment dramatically, and significant increases in interest rates have threatened the feasibility of even the strongest projects.

These new forces should impact how Congress reshapes the Opportunity Zone program to meet the moment. As a national coalition of real estate developers and investors who advocate for sustainable, equitable, and walkable development in America's communities, LOCUS is uniquely positioned to provide insight into how the Opportunity Zone program can be extended and reinvigorated to help deliver smart growth outcomes for communities. LOCUS has also previously led advocacy and capacity-building work related to Opportunity Zones since the program's inception, including technical assistance through the National Opportunity Zones Academy and creating resources such as the National Opportunity Zones Ranking Report.

How can Congress utilize Opportunity Zones to meet the country's housing and development challenges?

1. **Extend the Opportunity Zone incentive.** In an environment where it is increasingly difficult to build, the OZ incentive has helped bring new housing units online. Residential development is not incidental to the incentive, it's the core of what it has accomplished– over three-quarters of all OZ investments tracked by the accounting and consulting firm Novogradac included a residential component. In addition, while there is a cost to extending the program, there are also net new tax revenues that are generated during construction and operations that have secondary impacts in the community and state where the development takes place, including new funding for schools, transit, and public safety. Extending the base OZ incentive will also help create additional market-rate units, increasing housing supply, which in turn improves affordability.

2. **If Congress wants to further incentivize capital investment in housing, the OZ incentive should be made stronger for projects that produce housing to serve families making less than 100 percent of Area Median Income.** Providing an enhanced incentive for Opportunity Zone investments in housing in this price range would help tip the use of the incentive towards the creation of more housing with more affordable units. Congress could incentivize this type of development by allowing investors to receive a more significant reduction in tax liability on deferred gains for projects that include more affordable housing, rewarding investors based on the share of affordable units they create as well as the depth of affordability of those units. *See the example below.*

Illustrative Model for $1,000,000 gain with assumed 30% tax rate

Housing Units Brought on line by a Given OZ Development	Enhanced benefit for qualifying affordable investments held for 10 years	Initial deferred tax on capital gain paid after 10 years without affordability bonus	Remaining taxes paid after investment in described property with affordability bonus
100% of units affordable at 80% AMI or lower	Reduce deferred tax liability by 75%	$300,000	$75,000
75% of units affordable at 80% AMI or lower	Reduced deferred tax liability by 50%	$300,000	$150,000
50% of units affordable at 80% AMI or lower	Reduce deferred tax liability by 25%	$300,000	$225,000

3. **To support the redevelopment of existing assets and the efficiency of investments made through the OZ incentive, Congress should pursue some changes to the OZ incentive to improve its usability for preservation and rehabilitation projects.** As currently structured, it is difficult to utilize the OZ incentive to finance preservation and rehabilitation projects, because existing property must be improved by at least 100% of the property's acquisition cost to qualify for the incentive. As has been discussed by several actors in the OZ space, this threshold could be reduced significantly in the case of occupied properties that serve low- to moderate-income populations and distressed or vacant commercial assets in OZs. This could help expand the use of the OZ incentive into particularly distressed markets where ground-up new build construction projects have feasibility challenges.

4. **The OZ incentive could be further optimized to drive investment into downtowns in urban and suburban areas and rural main streets across the country by designating a set percentage of OZs within each state as "Core OZs," or "COZs,"** based on job and population density relative to the broader area and transit access (where reasonable). Investments made in Core OZs could be eligible for an additional tax benefit above and beyond what is currently offered through the OZ program or the value of the OZ benefit for any investment not in a COZ could be decreased. A COZ designation would help ensure further development maximizes the potential of existing assets and services first, before moving to areas where new builds would require significant new infrastructure investments.

How could other changes to the OZ program drive smart growth?

In addition to the housing production-focused priority policy changes discussed above, a host of other reforms to the program could help deliver smart growth by allowing for community participation and by providing the data needed to monitor and identify further improvements in the program.

- To extend access to a similar tax benefit to those without capital gains, Congress could consider creating a companion program to OZs that would support community members to invest in their own neighborhoods by allowing municipalities, counties, and/or states to establish funds designed to accept community donations, similar to crowdfunding, and offer a reciprocal tax benefit to individuals who contribute. This approach would expand the opportunity for wealth generation to communities targeted for investment.

- As proposed in recent bipartisan legislation, data and transparency provisions would allow Congress and the public to better understand the program as a whole. This understanding could help inform future revisions to the program.

As introduced in the 118th Congress, the bipartisan Opportunity Zones Transparency, Extension, and Improvement Act (OZTEIA) also seeks a host of reforms that could improve the program.

What OZs aren't

The OZ incentive isn't going to build something the local market can't support, replace thoughtful community planning, or serve as a substitute for other critical incentives such as the Low Income Housing Tax Credit or programs that provide funding directly to local governments for housing and community development projects. It's a financing tool that provides another means of driving capital into underinvested or otherwise distressed communities.

As a market-based tool, OZ investments often target optimal risk-adjust returns, with a preference toward communities with stronger investment fundamentals. Even if the program sunsets higher income tracts as has been proposed, the remaining universe of zones will still have different market conditions and locational advantages and will thus not see even levels of investment.

Certain policy adjustments might attempt to coerce OZ investments elsewhere with mixed success, but this tendency to cluster creates local market expertise in utilizing the incentive and creates redevelopment momentum. Opportunity Zone investments also do often slide into existing in-process deals with specific financing gaps rather than generate entirely new projects, (although there are some notable exceptions)., However that doesn't mean they aren't providing meaningful contributions to capital stacks.

Opportunity Zones are not the panacea for the housing crisis or the sole answer to spurring smart growth in distressed communities. They are, however, a powerful tool to drive capital into housing and redevelopment at a critical moment for the country's housing stock and downtowns. Addressing the housing supply crisis and supporting sustained growth on our main streets and in our downtowns are needs too urgent to remove a tool that could help deliver solutions.

About LOCUS and Smart Growth America

LOCUS, a program of Smart Growth America, is the only national coalition of real estate developers and investors who advocate for sustainable, equitable, walkable development in America's towns and metropolitan areas. LOCUS brings together real estate developers and investors from across the country to change policy at the local, state, and federal levels and to build neighborhoods that are more economically, socially, and environmentally sustainable for America's future.

Smart Growth America helps create healthy, prosperous, and resilient places to live for all people through research, advocacy, and direct community support. Our work spans housing and land use, transportation, and economic development to find solutions to communities' most pressing needs. We work with elected officials at all levels, real estate developers, chambers of commerce, transportation and urban planning professionals, and residents to improve everyday life for people across the country through better development.