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What Good Is OZ Reporting if We Don't Agree on the Goals?

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At a recent subcommittee hearing on the opportunity zones (OZ) tax incentive,[1] legislators seemed to inhabit two different worlds. The program was, alternately, a triumph for low-income individuals or a bonanza for high earners. But there was one thing both sides agreed on: there wasn't enough data to draw a conclusion.[2]

The need for more data on the business activities of qualified opportunity funds (QOFs) in low-income census tracts designated as qualified opportunity zones (QOZs) has long been a bipartisan concern. Originally, the bill did require reporting,[3] but this was stripped for procedural reasons. In the 116th Congress (2019–2020), five bills were introduced to add this back.[4] One of these, the IMPACT Act, was proposed by Senator Tim Scott, who introduced OZs in 2016.[5] Members of the Opportunity Zones Coalition, an industry group spearheaded by the Economic Innovation Group (EIG), the think tank which conceived of OZs, "strongly support the immediate establishment of reporting and transparency requirements for OZ investments."[6]

It is hard to be anti-information. However, this enthusiasm for additional reporting is premature. Reporting is not neutral. We need to know what we're looking for before we can find it. If Congress passes an OZ reporting statute without stating clearly what OZs are supposed to achieve, the data will change no one's mind. This is especially true with a program as subtle as OZs, which were devised to help communities overlooked by previous programs.

To break the gridlock, someone needs to first tell us what the goals of the program are — and what they are not. And if we want OZs to target a specific subset of low-income neighborhoods, its proponents need to be candid about which needy people they are *not* supposed to help, so we can count that as a success too.

THE EIG WHITE PAPER

The goal of OZs was opaque from the start. The first and last serious policy discussion before its passage was a "white paper" by two economists at EIG.[7] Written seven years after the 2008 recession, the 2015 Paper observed that the economy had gotten better,

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[1] *Oversight Subcommittee Hearing on the Opportunity Zone Program and Who It Left Behind*, Ways & Means Comm., U.S. House of Rep., 117th Cong. (Nov. 16, 2021).

[2] *Id.* Sen. Tim Scott (R-SC): "Without those reporting requirements there's no possible way to have an honest balanced hearing around the benefits that are really important to the poorest people of this country." Rep. Bill Pascrell (D-NJ): "We need such reporting requirements to know: are opportunity zones yet another tax incentive making the rich even richer? Is this program crony capitalism on steroids, with the government picking the winners and the losers?"

[3] Under the Investing in Opportunity Act, Treasury would annually report to Congress on "the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction, and new business starts, and other metrics as determined by the Secretary." S. Rep. 2868, 114th Cong. (2016); H.R. 5082, 114th Cong. (2016).

[4] GAO, Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance, GAO-21-30, n. 51 (Oct. 2020).

[5] Economic Innovation Group, Unpacking the IMPACT Act (Dec. 12, 2019).

[6] *Recommendations for Legislative and Regulatory Modifications to Opportunity Zone Incentive*, Economic Innovation Group, *et al.* (Mar. 21, 2021).

[7] Jared Bernstein and Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, Economic Innovation Group (Apr. 2015) (2015 Paper).

but not for everyone. And it asked: What's the best way to help those who have been passed over by an economic recovery?

The paper made two key recommendations. First, the private sector should drive the solution. Thus, we should make it economically rewarding for high-income taxpayers to invest in low-income areas. Second, the incentive should be carefully limited, so it channels investments into the most refractory pockets of low-income neighborhoods, the places that have previously been least attractive to investors.

These positions are contestable. For example, some experts object that OZs don't give enough control to local residents. As the Urban Institute notes:

> 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.[8]

However, the biggest surprise about the 2015 Paper is its lack of detail. Here we have the sole foundational text on OZs, the only public blueprint which Congress might have consulted in drafting the law, and it is incomplete. For example, in discussing possible tax incentives, the paper does not propose any end date for the initial deferral (whether 2026 or otherwise), nor does it firmly commit to a basis step-up of any kind.[9] The authors acknowledge this gap, explaining: ''[i]t is beyond the scope of this effort to develop a detailed proposal, an effort that we leave to future research.''[10]

According to David Wessel, this was intentional. He states that, ''[t]hrough this initial launch period, one thing went unmentioned: the specifics of an OZ tax break. The omission was deliberate. EIG was defining the problem in a way that would make it easier to sell Opportunity Zones as the solution.''[11]

Sean Parker built Napster, Facebook, and OZs. Arguably, OZs went viral because they offer a convenient narrative about charity and free enterprise: They make both look easy.[12] This got the bill passed, at the cost of rendering it incoherent.

THE LEGISLATION

If Americans remember OZs as a success, it will be in spite of how the law was drafted, not because of it. As the Urban Institute has noted, ''the structure of the incentive appears to be least workable for the projects that could have the highest impact around [the issues described in the EIG's 2015 paper].''[13] Daniel Hemel put it more bluntly: ''[i]t is difficult to see how anyone who genuinely sought to lift up communities left behind by the recovery from the Great Recession would have written the law this way.''[14]

For example, proponents of OZs claim that they encourage investors to maximize the growth of their investments in low performing communities. But is that good for those communities? In the context of the low-income housing tax credit, we don't reward investments with high returns; we try to make the investor whole to compensate her for accepting lower returns.[15] And assuming that rewarding these investments is a good idea, does the law really do that? Treasury takes the position (which I have argued is contrary to statute) that OZs forgive depreciation re-

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[8] See An Early Assessment of Opportunity Zones for Equitable Development Projects. Urban Institute (June 2020) (Urban Institute).

[9] 2015 Paper at p. 18. The authors state: ''A number of important options must be considered when devising the special tax provisions to be applied to investments in distressed regions. . . . For example, unrealized capital gains might be rolled over into special funds constrained to invest in distressed communities, with the capital gains taxed only if the money is withdrawn from the qualified funds down the road. A similar treatment could apply to direct investments in enterprises within the Qualifying Investment zones. Depending on how generous Congress would like the incentive to invest to be, the capital gains basis of the unrealized gain could be adjusted/''stepped up'' in some manner as well. The generosity could be linked to the type of investment, with investments in infrastructure, for example, receiving more generous treatments.''

[10] *Id.*

[11] David Wessel, *Only the Rich Can Play,* Public Affairs (Oct. 5, 2021), p. 78 (herein ''Wessel'').

[12] See Andrew Gradman, *QOZ Planning When Penalties Are A Certainty,* California Tax Lawyer, Vol. 31, No. 2 (2022) (arguing that the OZ program was ''deliberately designed to attract investors who are unprepared to comply with all its rules'').

[13] Urban Institute (June 2020).

[14] Daniel Hemel, *A Place for Place in Federal Tax Law,* 45 Ohio N.U. L. Rev. 525 (2019). He adds: ''The legislation is so poorly designed that one wonders whether the flaws might have been intentional: whether this was simply a cynical attempt to give tax breaks to rich donors and more work to well-connected lawyers, all under the guise of aid to distressed communities.''

[15] As the Urban Institute puts it: ''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.'' *Id.* Also, some argue that allowing OZ investments at the interface between low-income and high-income neighborhoods promotes gentrification, which is bad for those neighborhoods. *See Promise and Opportunity Deferred: Why the United States Has Failed to Achieve Equitable and Inclusive Communities*, Center For American Progress (Feb. 2020).

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capture. This encourages fund managers to resurrect the practices of 1980s-style leveraged tax shelters, with no rational connection to helping low-income people.[16]

In any event, we won't even get to that point, until we get people to invest in low-performing communities. Not all communities designated as QOZs are equally needy. The incentive pushes investors away from the lowest performing, neediest ones, and towards the least needy, highest performers. Even OZ's founders acknowledge this perverse incentive. According to an influential guide, co-edited by EIG's Steve Glickman:[17]

> Keep in mind, the tax benefits afforded an OZ investor will not make an unprofitable investment a good one. Like most private placement equity capital solicitations, an interested investor may face a plethora of questions and choices, including: . . . With more than 8,700 [QOZs], does the specific QOZ make a difference? We think the answer, especially for real estate investments, is an unequivocal ''yes.'' How does the investor then compare the economies of one QOZ against another?

Many governors made the same calculation, designating less-impacted communities as QOZs in order to be more competitive with other QOZs in the country.[18] But if one follows this logic far enough, it should also be no surprise to learn that there are fund managers who openly advertise that they will try to invest only in areas that are *not* underprivileged. Here's an example of some typical marketing material:

> ''Opportunity Zones are, by definition, communities with below average incomes and higher poverty rates, and census tracts designated as Opportunity Zones tend to have relatively high unemployment and low home values. That said, we have found that it is, in fact, possible to identify individual OZ locations that have surprisingly strong growth potential. One way of doing this is by leveraging predictive demographic data, using variables that can be forecasted with reasonable accuracy — examples include income and population growth data, key drivers of long-term real estate demand that have historically been projected with reasonably high accuracy. We also internalize structured and unstructured data around points of interest, drive times, influence from adjacent census tracts, and walkability & transit orientation. We then rank the more than 8,700 Opportunity Zone census tracts, identifying clusters of higher scoring OZ areas and narrowing in on a subset of those clusters where we believe our operating partner network will have actionable investment opportunities and relevant local insight.''[19]

Stripping away the euphemism, this sponsor claims to have devised an algorithm to ensure it will only invest communities with the highest performance potential — by implication, the communities with the least need for tax-subsidized investment. This is cynical, but not radical. I have always encouraged my own clients to seek out fund sponsors that take this approach.

The data suggests that our clients are heeding our advice. A study of a large sample of tax forms filed by QOFs for 2019 shows that 84% of the 8,764 QOZs got no OZ investment at all. Half the money went the best-off 1% of QOZs.[20] This is ironic, because OZs were conceived of as a rescue plan for communities that were left behind by the booming 2015 economy. If it turns out that the disparity between QOZs is significant, then those left-behind communities will also get left behind by the rescue plan.

THE ORIGINAL SIN OF OZs

The biggest gulf between the 2015 paper and the OZ statute is due to the paper's failure to propose a definition for the geographic area of the QOZs. Ultimately, Congress filled this vacuum by incorporating the concept of ''Low-Income Communities'' from the New Markets Tax Credit, §45D(e)(1).

In David Wessel's exhaustive history of the OZ program, this fateful decision seems to have been

[16] See Andrew Gradman, *How Forgiving Recapture Gain Turns QOZs Into Tax Shelters,* Tax Notes Federal (Nov. 2019). After this article was published, Treasury modified Reg. §1.1400Z2(c)-1(b)(2)(i) in a way that makes it easier to use leverage to extract depreciation deductions from a QOF. *Compare* REG–120186–18, 84 Fed. Reg. 18,652, 18,685 (May 1, 2018) (text of Prop. Reg. §1.1400Z2(c)-1(b)(2)(i)) with T.D. 9889, 85 Fed. Reg. 1866, 1974 (Jan. 13, 2020) (text of Reg. §1.1400Z2(c)-1(b)(2)(i)). All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[17] *See* The Guide to Making Opportunity Zones Work, CohnReznick (Oct. 2020).

[18] *See* Wessel at p. 123 (''[t]his was a fundamental question confronted by thoughtful governors: should a state designate the worst-off neighborhoods, even though they had little chance of drawing private investment, or should it pick less challenging areas that private investors were likely to find attractive?). The original OZ bill said that governors should ''strive'' for ''contiguous clusters of census tracts'' and should favor tracts that were already the focus of efforts to attract investment, had successfully used other incentives, or had ''recently experienced significant layoffs due to business closures or relocations.'' This was cut from the final bill. *Id.* at p. 112–13.

[19] Cadre, Opportunity Zones: OZ Investing (Oct. 16, 2020).

[20] Patrick Kennedy and Harrison Wheeler, Neighborhood-Level Investment from the U.S. Opportunity Zone Program: Early Evidence (Apr. 15, 2021).

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made lightly: ‘‘Parker and the EIG boys thought it would be simpler, and politically expedient, to piggy-back on the NMTC definitions as opposed to creating their own . . .’’[21] In my view, this was OZ's original sin. Low-Income Communities are just census tracts. Census tracts are just 8,000 people. Using census tracts may have made sense in the context of NMTCs, where accountability to local communities was essential to the design.[22] But in the 2015 Paper, when the authors were talking about distressed communities, they weren't talking about small units like neighborhoods. They were talking about large units — whole cities.[23] They mentioned El Centro, CA; Merced, CA; Yuba City, CA; Modesto, CA; Fresno, CA; and Detroit, MI. The reason they concerned themselves with these large islands of poverty is because they were talking about a particular kind of downward spiral — the downward spiral that happens when there isn't an affluent neighborhood near you, when you can't just get on a bus and look for work in a more affluent part of town. The 2015 Paper is talking about communities with:

> distressed and traumatized workers who face plummeting incomes, stalling career progressions, and cracking self confidence. . . . The difficulty with which unemployed workers relocate — often staying in place due to social factors even when geographical wage differentials exist — creates a vicious cycle of persistently high unemployment in the same places.

The goal of OZs, according to the 2015 Paper, was not simply to help low-income individuals. It was to target those individuals and families who have benefited least from previous forms of help. This is a subtle distinction. OZs were not just a new method to address an old problem. The authors argued that the nature of poverty in America had changed. Instead of addressing poverty head on, we needed to address its structure, i.e., its propensity to concentrate in rural communities and similar isolated deserts. Trickle-down economics works only when poor people have convenient access to rich people, and many do not; those are the ones that OZs target.

By defining QOZs in terms of Low-Income Communities from the NMTC, the OZ program doomed itself from the start.

OTHER AGENCIES

The lack of a clear purpose in the OZ statute has been noticed by other government agencies. In a proposed regulation, Treasury initially provided for an anti-abuse rule as follows:

> [These regulations] must be applied in a manner consistent with the purposes of section 1400Z-2. Accordingly, if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of section 1400Z-2, the Commissioner can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 1400Z-2.’’[24]

This language is not novel. Most recently, in October 2017, similar language appeared in Reg. §1.597-3(g), relating to banks. However, in the case of OZs, Treasury felt the need to refine this language further. In the final regulation, Reg. §1.1400Z2(f)-1(c)(1), Treasury added this explanation:

> The purposes of section 1400Z-2 and the section 1400Z-2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments, through QOFs and qualified opportunity zone businesses, of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones.

This text adds nothing of substance. The whole exercise suggests that in the case of OZs (but not in the case of banks), Treasury concluded that the public could not be expected to discern the purposes of the statute — because Treasury couldn't either.

The GAO encountered the same problem. In October 2020, it responded to a Congressional request to

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[21] Wessel, p. 83.

[22] §45D(c)(1)(B); *see* NMTC Working Group, Recommended Practices for Satisfying the Accountability Test.

[23] The 2015 Paper further stated that: ‘‘[e]xtremely high unemployment in cities such as Fresno, Yuma, or Detroit leads to pockets of distressed and traumatized workers who face plummeting incomes, stalling career progressions, and cracking self confidence. . . . While much of the popular policy conversation focuses on income disparities among individuals, geographic disparities are an equally important part of American life. . . . Older generations have the strong social ties to families, friends, and culture that prevent them from moving away, so instead they remain in areas with stalled or declining fortunes. Distressed communities, in essence, face very high transition costs. All the while, better-off cities receive a federal subsidy from the tax exclusion of state and local taxes from federal taxation. . . . The difficulty with which unemployed workers relocate — often staying in place due to social factors even when geographical wage differentials exist — creates a vicious cycle of persistently high unemployment in the same places.’’

[24] Prop. Reg. §1.1400Z2(f)-1(c)(1), REG-120186-18, 84 Fed. Reg, 18,652 (May 1, 2018).

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"review OZ implementation." In its study,[25] it declined to answer Congress's question. It explained, "[a]s a result of unclear statutory authority, there are insufficient data available to evaluate OZ performance," and that "[a]dditional data collection and reporting on OZ are necessary to evaluate outcomes."[26]

GAO then made a further recommendation: "Congress should also consider identifying questions about the performance of the Opportunity Zones tax expenditure that it wants Treasury, in collaboration with other agencies, to address in order to help guide data collection and reporting of performance, including outcomes." In other words, GAO acknowledged that it could not evaluate the program even if it had the data, because it did not know how Congress was measuring success.

CONCLUSION: THE PROBLEM OF SHIFTING GOALPOSTS

When we lack good data, it is tempting to substitute something more accessible but less meaningful.[27] With OZs, we did that when we piggybacked onto Low-Income Communities as the definition of QOZs, without asking whether these promote the goals of OZs. We do it again when we measure the success of OZs by the number of dollars invested through the program, as if this was an end in itself, without regard to the quality of the QOZ or the use of funds.[28]

And we will do it again if we create new rules requiring more reporting from QOFs, without first agreeing on how we define success. Without this framework, the response will simply be to shift the program's goalposts to reflect whatever benefits appear in the data. As we in the tax community understand, the persons who controls the reporting controls the decision-making.

[25] GAO, *Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance,* Note 4, above.

[26] *Id.*

[27] *See* Streetlight effect, Wikipedia.

[28] Again, in the Senate Committee hearing, Tim Scott (R-SC): "You can measure the results. Look at the numbers. We've seen historic capital being poured into low income communities. GAO notes that in just the first year of opportunity zone programs, we've seen $29 billion have been invested in low-income, high-poverty, racially-diverse areas." *Oversight Subcommittee Hearing on the Opportunity Zone Program and Who It Left Behind,* Note 1, above.

To give an example, after the New York Times published an article criticizing the designation of certain affluent communities as QOZs,[29] one of the authors of the EIG's 2015 Paper tried to deflect this attack by suggesting that the Times was really just criticizing the inclusion of mixed-income communities. He pointed out that mixed-income communities benefit their low-income residents.[30] This may be true. But that wasn't how he originally sold OZs to us. OZs were for people for whom mixed-income housing was not an option, because they did not live near people with higher incomes.

Even if the OZs made sense in 2015, it's possible that America has changed enough in the last seven years to justify new solutions. When the paper was written in 2015, the authors described a fundamentally good economy. The challenge was how to spread that wealth to people who had been overlooked by the recovery. Since then, Covid-19 and global tensions have transformed the economy. OZs may have become an anachronism.

For these reasons, while there may be bipartisan support for requiring more reporting from QOFs, I hope the debate over the content of the reporting is itself controversial, because this debate could be the first time Congress questions what purposes OZs ought to serve. Members of Congress should have to come out and say whether Oakland deserves to have any QOZs. If it does, EIG will need to write another paper explaining what OZs are *actually* trying to accomplish.

[29] Jesse Drucker and Eric Lipton, *How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich*, New York Times (Aug. 31, 2019) The article states that "billions of untaxed investment profits are beginning to pour into high-end apartment buildings and hotels, storage facilities that employ only a handful of workers, and student housing in bustling college towns, among other projects. . . . there are plenty of affluent areas inside those poor census tracts."

[30] Jared Bernstein Blog On The Economy, *The NYT wrote a woefully imbalanced piece on Opportunity Zones* (Sept. 3, 2019). The blog stated that "[a] good chunk of what the [New York Times] piece bemoans is actually about building in mixed-income communities. Many of us view this as a potentially positive outcome of OZs. There's solid social-science research showing the benefits to the poor, especially for young children, of growing up in such places relative to high poverty areas."

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