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# Investing in the Land of O.Z.: The Promise of Qualified Opportunity Zone Investing in Ameliorating Urban Blight

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# Honors Thesis Approval Page

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# Investing in the Land of O.Z.:
# The Promise of Qualified Opportunity Zone Investing
# in Ameliorating Urban Blight

A Thesis

Presented to

The Faculty and the Honors Program

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By

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**Abstract**

In 2017, President Trump's landmark Tax Cuts and Jobs Act introduced one of the most prolific federal incentives for real estate development in decades. In an effort to stimulate investment in neglected neighborhoods across all 50 states and five territories, the Federal Government authorized the designation of almost 9,000 blighted census tracts across the country as eligible for tax incentives. Investment in these tracts, deemed Qualified Opportunity Zones, allow investors to receive substantial capital gains deferral and possible capital gains exclusion at the end of the designated holding period, assuming they comply with the regulations of the program. While designed to revitalize economically distressed communities and reward risk-taking investment, these programs have come under scrutiny from both community residents and investors alike. In the eyes of many, this program has thus far seemingly failed to yield the intended outcome, with reports that the actual total investment pales in comparison to the expected figures. This paper seeks to examine the financial, social, and bureaucratic factors driving the program's perceived failure to excite investor capital into Qualified Opportunity Funds, the investment vehicle of QOZs. Moreover, this paper will provide data analysis as to whether early figures show a substantial increase in investment in these communities. Ultimately, this research will provide an assessment of the efficacy of the QOZ program based on the tangible improvement it provides in distressed communities, its correlation with the characteristics of gentrification, the successful translation of QOF investment into completed developments, and investor return.

## Definitions and Abbreviations:

**Opportunity Zone (OZ)/Qualified Opportunity Zone (QOZ)/O-Zone**:

The Internal Revenue Service (2020) defines An Opportunity Zone as “an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as opportunity zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service”.

**Qualified Opportunity Fund (QOF)**: The Internal Revenue Service (2020) defines a Qualified Opportunity Fund as “an investment vehicle that files either a partnership or corporation federal income tax return and is organized for the purpose of investing in Qualified Opportunity Zone property”.

"It didn't happen". These were the words of Marlene Cintron, the President of Bronx Overall Economic Development Corporation, when speaking on the results 2017 Tax Cuts and Jobs Act's Opportunity Zone program (Rippetoe 2020). Her terse words refer to the investment, or lack thereof, from the private sector that was projected to flood into low income neighborhoods as a result of government tax relief tied to investment in the Opportunity Zone initiative. Cintron's comments reflect a myriad of similar sentiments from community leaders and residents of blighted neighborhoods across the United States who have been promised economic revitalization through this program.

Conversely, in a world away, Opportunity Zones became the darling of the real estate development world shortly after their announcement. At the peak of their excitement, developers walked around high profile conferences donning signs that unabashedly proclaimed "Looking for OZ Funds". To developers, it seemed like OZs[1] were too good to be true. Talk of this program caused such a frenzy and became so ubiquitous in the industry that Investor Mark Cuban commented that "every major investor I know has been pitched a property or fund within an OZ" (Drucker & Lipton, 2019).

These two perspectives tell a drastically different story of the efficacy and merit of this dynamic program and its sweeping tax incentives. The optics of this disparity certainly point toward the program as being a zero-sum game, with the wealthy receiving all the spoils. Though this conclusion lends itself nicely to sensationalist literature about the rich getting richer off a program designed to help the impoverished communities, such a headline cannot be extrapolated that simply. Opportunity Zones are inherently a long term game. It is not fair nor productive to assess the program in its totality until all the investment deadlines have passed and then some

[1] The terms Opportunity Zone, OZ, Qualified Opportunity Zone, QOZ, and O-Zone will be used interchangeably for the purposes of this Thesis

additional years have passed to allow for asset stabilization and maturity. Only then can the full impact of the program be assessed and critiqued.

Having just passed the deadline for investors to receive the full benefits of the program on December 31st, 2019, the rollout, implementation, and structure of the program are effectively finalized and the first of three waves of investment have concluded. Based on this first phase of investment, it is undisputable that there are clear deficiencies in the program, particularly in its administration. Despite some of its more egregious shortcomings, the program remains the most prolific and effective attempt by the Federal Government at remedying the investment disparity between blighted and prospering neighborhoods in over half a century. Moreover, the byproducts of this program will play a role in mitigating the affordable housing crisis and minority underrepresentation in home and business ownership, among other concomitant issues.

Given the program's reputation, which at worst portrays the program as a windfall for wealthy developers and at best as a muddled program with poor guidelines and vague regulatory language, it is difficult to envision a future where this program effects serious systematic change. Ultimately, despite this current reputation, analytical data shows a marked increase in construction and sales volume in these census tracts from the announcement of the program in 2017 to today. The data analysis in this paper shows that Opportunity Zones engendered improvement in multifamily construction starts, property acquisitions and capital rate compression in their respective neighborhoods. This data suggests that the program has categorically increased private investment in these communities since 2017 by way of a 32% increase in construction and a 40% increase in sales volume in that time. Moreover, capitalization rates in Opportunity Zones have compressed by almost 30 basis points in that same timeframe.

Given that all of these metrics exceed the average national rate of increases in that time, it can be concluded that the designation of tracts as Opportunity Zones contributed significantly to the investment in and value appreciation of those communities.

## Background

### History

#### *Formalization by Bernstein and Hassett*

The Opportunity Zone Program was first formally conceptualized by Jared Bernstein and Kevin Hassett of the Economic Innovation Group in a 2015 white paper entitled *Unlocking Private Capital to Facilitate Economic Growth in Distressed Area*. Motivated by the geographic and class-based disparities in recovery from the Great Recession coupled with simultaneous massive gains in the stock market, these economists sought to provide a new public incentive for private investment that freed the capital tied up in the unrealized capital gains. Their impetus for suggesting the creation of this program arose from what they viewed as the unequal nature of the recovery from the Great Recovery.

Particularly, they noted unevenness across geography and income levels, "while certain areas of the country are doing remarkably well and nearing or exceeding their pre-recession economic states…large swaths of the country fac[e] chronic rates of long-term unemployment and historically low levels of new investment (Bernstein and Hassett, 2015). For instance, while financial hubs like San Francisco saw unemployment levels dip below 5%, cities like nearby Fresno still toiled with minimal economic growth and 11% unemployment (Bernstein and Hassett, 2015). This phenomenon proliferated across the country as select cities and areas saw the bulk of the recovery while others faced stagnation. Naturally, this caused people to flee decaying areas for cities with better opportunities, thereby amplifying the problem. As a result, these already depressed cities experienced “declining private activity and a falling tax base…lead[ing] to a drop off of [in] public investment and infrastructure, making it even more difficult to attract private capital” (Bernstein and Hasset, 2015).

They note that while countless cities and neighborhoods across the country were starving for private investment, the S&P 500 nearly tripled in that time, amounting to almost 2.4 trillion in unrealized locked up capital gains. Though Bernstein and Hassett did not formalize any concrete program or guidelines for the federal government to redeploy this capital, they diagnosed a problematic outcome of the way private capital is invested in this country. Moreover, they provided the novel groundwork for a system that draws equity from the massive pool of unrealized capital gains and utilizes concentrated investments from hedge fund-like entities to inject capital into neglected communities. It is this framework that would evolve into Opportunity Zones as they exist today.

***Sean Parker and Birth of Opportunity Zones***

Bernstein and Hassett’s paper became the catalyst in driving this idea into legislation. But the idea originated several years earlier in the mind of Napster founder and former Facebook President Sean Parker, when he visited Tanzania and lamented that the country would likely never attract the private investment needed to combat its systematic causes of poverty. This pattern of thought reminded him of the countless blighted and distressed areas at home in the United States suffering from the same lack of investment. Around this same time, his Facebook equity was reaching astronomical levels, noting that "people were sitting on large capital gains with low basis and huge appreciation. There was all this money sitting on the sidelines … I started thinking, ‘How do we get investors to put money into places where they wouldn't normally invest’” (Bertoni, 2018).

This realization allowed Parker to envision a program that unlocked those capital gain to stir investment in these dire communities without fear of incurring capital gains tax. Though he could not change policy in Africa, someone of his status and net worth could certainly influence it in the United States. Quickly after marrying the concept of tax free capital gains investment to investment in blighted areas, Parker became the public champion of this idea and quickly garnered “a wide-ranging coalition of investors, entrepreneurs, community developers, economists, and other stakeholders” (Economic Innovation Group, n.d.). His thinktank, the Economic Innovation Group, became the conduit through which the idea was institutionally formalized and researched, resulting in Bernsetin and Hassett’s white paper. All the while, Parker drummed up institutional support in Washington and pitched his idea to congressmen and lobbyists from across the political spectrum. Its goal of investing in impoverished communities drew the eye of Democrats while its tax-cutting mechanics won its favor with Republicans.

The Economic Innovation Group had built up a bipartisan coalition of 72 legislators in support of the proposal, including Senators Tim Scott (R-South Carolina) and Cory Booker (D-New Jersey), who became the sponsors that introduced the Investing in Opportunity Act in 2016 (Bertoni, 2018). Instead of passing on its own, lawmakers eventually included it as a provision of President Trump’s landmark Tax Cuts and Jobs Act in 2017. Spelled out in just six pages, Opportunity Zones were signed into law by President Trump on December 22nd, 2017 (Tax Cuts and Jobs Act, 2017). Thus, in the span of a decade, Parker’s vision had become a reality.

## The Nomination Process

### *Delegation of Nomination Duties*

Following the legal creation of the program, it became critical to determine which communities would be eligible for these potent tax incentives as an obvious prerequisite to opening the floodgates to private investment. In order to most accurately pinpoint the communities in the most dire need of private investment, the Department of the Treasury asked all 50 governors, the Mayor of Washington D.C., and the governors of the 5 American territories (Guam, Puerto Rico, Virgin Islands, American Samoa, and the Northern Mariana Islands) to recommend up to 25% of their respective state's Low-Income Community census tracts for O-Zone designation. If states have less than 100 low income community tracts, then Governors were allowed to nominate up to 25 of these tracts for O-Zone consideration (EIG, 2018).

***Low Income Communities***

The Treasury Department defined Low-Income Communities (LICs) by borrowing the verbiage from Section 45D(e) of the Tax Code on New Market Tax Credits. This language defined Low Income Communities as census tracts in which the poverty rate is at least 20%. Alternatively, tracts could also meet the qualification if they did not exceed 80% of the statewide median family income. In addition, metropolitan tracts could qualify if they did not exceed 80% of the greater metropolitan median family income (26 U.S. Code § 45D). Furthermore, up to 5% of a governor's nominations were allowed to be tracts that did not meet the LIC standards as long as they were contiguous to another nominated LIC and did not exceed 125% of that LIC's Median Family Income (26 CFR § 601.601). In addition to these governor nominated tracts, Section 41115 of the Bipartisan Budget Act of 2018 automatically designated every low income tract in Puerto Rico as a Qualified Opportunity Zone, effectively turning the entire island into one giant O-Zone (P.L. 115–123).

Though not federally mandated, similar scenarios occurred *de facto* with the other four American territories as their relative size and poverty allowed their governors to designate large swaths of their respective islands as O-Zones using the 25 tract allowance for states/territories with under 100 LICs. For instance, Guam only has 31 eligible LIC tracts and under 60 total census tracts, meaning that almost all (25 out of 31) of its eligible tracts were selected, and therefore almost half the island is designated as an Opportunity Zone (Sherman 2019). This reality presents unique opportunities for relatively low-cost investment on a grand scale. Comparing this to a dense urban tract in Los Angeles demonstrates the investment variety that exists as a result of this program. After weighing these unique advantages found in each zone put up for nomination, the recommendation of 55 governors and the mandate of one federal act formed the final shortlist that the Treasury Department's used to compile the 8,762 census tracts across the country and its territories to be primed for large-scale federally incentivized private investment.

***Nomination Concerns***

**Developer Influence at the local level.** The nomination process presented a double-edged conundrum for lawmakers. By localizing the selection process, the federal government was striving to target the most in need communities. Naturally, it follows that local leaders are more attuned than federal bureaucrats to the needs of their constituents and exactly where that need is the strongest. Conversely, governors and local leaders are much closer to source of the potential beneficiaries of the potential capital gains windfall. Given the nature of their work, developers often work closely and have established relationship with city and state officials. Indeed, many developers are politically active, both with their donations and their own aspirations for office (after all, President Trump spent his life as a developer before pursuing office). To this end, a justified fear arose that developers would be able to influence the selection of tracts for nomination to benefit their own future projects or even ones already in the pipeline.

This potential issue was exacerbated by the reality that the Federal Government did not provide any guidelines or regulations for governors apart from submitting a shortlist. Approaches used varied widely, with governors setting up committees, sourcing community applications, directing state departments to research specific tracts, or delegating the task to local officials (Reilly 2018). Some governors consulted stakeholders from residents to legislators while others made selections with little outside input. This variation was engendered by the lack of federal supervision, which critics of the program derided as the means through which the program would be derailed from its intended purpose before the first dollar was even invested. University of Texas economist Nathan Jensen summarized this sentiment by noting, "That's the real scary part of this program, that you give such incredible power to politicians to designate zones…The fact that this process was not transparent in almost any state is shocking" (Elliot et. al, 2019).

**Contiguous zone loophole.** The bulk of the concern surrounding the localized nomination process stems from the inclusion of the contiguous zones provision in the nomination process. Their concern follows that this rule will become the mechanism through which developers can receive preferential capital gains treatment for investing in already gentrifying areas wherein investment would have occurred regardless of federal incentives. This fear has merit, since the law was actually designed to include of a limited number of contiguous zones creates flexibility for Governors to aggregate census tracts into a collection of opportunity zones that followed the natural boundaries of neighborhoods and communities which may not all homogenously qualify as LICs. To this end, investment will be able to revitalize entire communities rather than just a part of them. Moreover, investment is more likely to occur in areas surrounded by other opportunity zones rather than in isolated zones surrounded by blighted

LICs ineligible for investment incentives. Nonetheless, the ultimate decision by the Treasury Department resulted in only 230 (2.6%) of the 8,762 census tracts designated being these contiguous zones, just over half of the 5% that was permitted (Theodos, et. al, 2018).

**Abuses of the system.** Despite only a small percentage of the federally designated O-Zones ending up in contiguous zones, once the final list was revealed, bountiful controversy arose from some the inclusions. Though the specifications of the selection criteria mostly insulated the process against corruption, some developers were able to grandfather their already proposed projects into the program through underhanded backchannels. Notably, developers in several states were able to successfully personally appeal to their respective governors to have the tracts of their already planned projects included in the O-Zone nomination shortlist. In Florida, developer Wayne Huizenga Jr. was able to secure QOZ status for his redevelopment at the Rybovich Superyacht Marina in West Palm Beach. A week after Huizenga penned a now-leaked letter to Governor Rick Scott asking for O-Zone designation on the marina site, Scott approved the request from one of his biggest donors while rejecting requests from poorer tracts in West Palm Beach that lacked already planned multimillion dollar redevelopments (Elliot, et. al 2019). Miami's "Condo King" and Scott donor, Jorge Perez, who is also an investor in the marina deal told Bloomberg, "It worked as a market-rate rental. Now, it works that much better as an opportunity zone" (Levin, 2019).

While these cases may appear extreme, there are other examples even in the same state of Florida. In Tampa, city officials requested the inclusion of tracts in the downtown area primed for development by billionaire Scott donor Jeff Vinik near the Tampa Bay Lightning arena (a team owned by Vinik), where he has been planning for the development of luxury apartments alongside upscale hotels and retail since 2014. In Chicago, two QOZs located along the affluent lakefront and near downtown fail to meet any of the LIC or contiguous community nomination criteria (Nitkin 2019). In Detroit, tracts dominated by billionaire and Trump donor Dan Gilbert were among a handful of national tracts that did not meet federal eligibility requirements but were nonetheless designated as a QOZ (Coudreit 2019). Similar stories can be found in Baltimore, Las Vegas, and New Orleans among others that have likely gone uncovered (Ernsthausen and Elliot).

**Demographics of chosen tracts.** While the preceding examples suggest the program may be rife with cronyism, the reality is that the overwhelming majority of tracts were justly chosen. A study by the Urban Institute shows that designated tracts have a 10.63% higher poverty rate, 3.88% higher unemployment rate, and a $25,000 lower average property value than eligible non-designated tracts. In addition, designated tracts have significantly higher minority populations than their eligible non-designated counterparts, thereby incentivizing investment towards the populations most whose communities are the most capital starved (Theodos et. al, 2018). Though much scrutiny has been levied against the select crony zones outside the eligibility framework (albeit rightly so), these investors and developers will not see any direct benefits from the program.

**Exclusion of Current Projects**. Preferential capital gains treatment applies only to new equity invested in a Qualified Opportunity Fund. Seeing as the developers in the preceding examples already owned the land prior to QOZ designation, they cannot personally benefit unless they intend on soliciting new equity partners and form a QOF. In addition, they will need to substantially improve the current property or complete new construction to receive any preferential tax treatment. However, it is likely these projects will tertiarily benefit from the 13.5% increase in non-vacant land property values that owners in QOZs have experienced since their designation in 2018 (Sage et. al., 2019). Yet, even this benefit is unlikely to result in any tangible gain for the billionaire developer class the media has concerned itself with when critiquing the OZ program.

To understand how QOZ designation might benefit existing land owners, consider the West Palm Beach Marina Project. To realize any gain from increased property values alone, Huizenga would have to unload his ownership in these tracts to a QOF looking to take advantage of the program. Though the increase in property values in QOZs suggests he would show a gain on the land, it is hard to envision a scenario wherein the gain based solely on the appreciating land value eclipses that of his multimillion dollar phased redevelopment project. Seeing as he has held this land and been planning grand redevelopments for several years, he likely has significant sunk and carry costs associated with the entitlement and preconstruction phase, rendering this nominal increase in property value from QOZ designation an entirely unrealized gain.

Even if the spread between the appreciating land value and sunk redevelopment costs constituted a gain (which it almost certainly does not) it would pale in comparison to the increase in the land residual value that the eventual redevelopment of the Marina will provide. At most, this designation will attract new development to the tract area not owned by Huizenga and drive up the reversion value of Marina project in that way. Again, this argument is rather fruitless as the scale of investment into the Marina will naturally attract further complementary investment with or without the QOZ designation. While it is lamentable that some tracts were undeservedly selected while others were left out, they ultimately constitute a fractional percentage of the almost 9,000 tracts selected nationwide.

As the Urban Institute data shows, the chosen tracts have a higher overall need for investment than those left out. Even if every tract chosen provided a windfall for developers, it would still be a net benefit for the communities that otherwise would not have received the investment. As much as the media surrounding OZs paints it to be the case, Opportunity Zones do not have to be a zero-sum game. Community revitalization can occur simultaneously with generous developer gains. For these reason, a handful of stories about developers "gaming" the system should not detract from the overall efficacy of the QOZ program.

## Previous Iterations

### *Failed Predecessors*

As innovative as Opportunity Zones are, this is not the Federal Government's first attempt at attracting private investment to distressed communities with tax incentives. During the Carter Administration, Urban Development Action Grants were created as one of the earliest attempts to pair Federal incentives with private capital. The program, though successful in attracting investment into a limited amounts of distressed areas, was assessed by HUD to have failed at alleviating blight in the neighborhoods of these projects (Reed, 1989). Moreover, the HUD Impact Evaluation of UDAGs (1982) conceded that the approach of the program was too top-down and that "federal funds have been awarded for projects that would have been completed without the UDAG subsidy".

This same fear circulates in the press about the Opportunity Zone Program today; there is an innate fear the Federal incentives meant to help the poor will be pocketed by the rich. Later programs like the Clinton era Empowerment Zone Program created the eponymously named Empowerment Zones, Enterprise Communities, and Renewal Communities, which provided a mixture of employment tax credits and capital gains relief to qualifying businesses within those geographies. Opportunity Zones thrive where Urban Action Development Grants, Empowerment Zones, Enterprise Communities, and Renewal Communities failed because of their scale, scope, and administration.

All of the aforementioned predecessor programs were significantly limited in scale compared to Opportunity Zones. For instance, HUD's Empowerment Zone website (n.d.) shows that the program only allocated less than 100 EC zones and 20 EZ zones across each of its three phases. No EC, RC, or EZ that was designated had a population over 200,000. While it is important to help rural communities, this demonstrates the incredibly limited scale of these programs. Moreover, these expired programs relied on a competitive award system to allot communities their respective designation. This not only pitted cities in competition with one another, but also necessitated that they compiled a comprehensive strategic vision for investment that took into account input from all their stakeholders.

The Federal's Government's requirement of a submitted strategic plan that has to best other communities is no easy task for areas already starved of capital and institutional infrastructure. Compare this system to Opportunity Zones, where almost 9,000 census tracts and their 35 million residents were primed virtually overnight for an influx of private investment without a lengthy and competitive application process (US Census American Community Survey, 2014-2018). While some mayors and community leaders are strategically positioning their communities to be at the top of QOFs' shortlists, no action was required on behalf of QOZ residents to earn said designation (Tubbs 2019).

In addition, Opportunity Zones can thank the internet age and their indelible association with the Trump Administration for their intense scrutinization in the media that has led a certain level of notoriety. One of the biggest failures of the EZ Program is that is suffered from underutilization. A Government Accountability Office Survey (1998) showed that 40% of eligible businesses did not claim the EZ tax credits because they did not know they existed. Given the 173 million search results that populate Google upon searching “Opportunity Zones”, it is incredibly likely OZs will have such a problem.

### ***Successful (but limited) Iterations: New Market Tax Credits***

The most successful cousin of OZs is a newer program still in existence today, New Market Tax Credits. Much like OZs, the intention of NMTCs is to attract private capital to underserved communities through Federal Tax Credits. These credits can be earned by investors for private equity investment in a Community Development Enterprise (CDE), an entity not unlike a QOF, that in turn invest in businesses and real estate in LICs. The large difference is that all CDEs are competing for a finite number of tax credits that is annually reviewed by Congress. This system means that an investor can invest in a CDE, the CDE can be entirely compliant in its operations within an LIC, and still that investor can emerge with no tax credits for his equity contribution.

Because of this reality, Bateman (2018) notes that NMTCs have a fixed amount of investment that can occur in LICs every year whereas Opportunity Zones have unlimited investment potential since any capital gain can be invested into a QOF and receive the benefits so long as the QOF is compliant. For this reason, OZs have exponentially more potential to spark private investment; the only barrier to entry is having a capital gain.

# Investing

## The Mechanics of Opportunity Zones

### ***Authority***

Though Opportunity Zones were signed into law and the zones were finalized, very little was understood about them in the months following their passage given the lack of regulatory and explanatory language in the legislation itself. Packed into just six pages of an otherwise comprehensive reform of the tax system was seemingly one of the most powerful tools for incentivizing private investment in decades. Despite its evolution over the course of several rounds of regulatory guidelines, the core functionality and mechanisms of Opportunity Zones have remained constant since its inception in 2017. The authority to implement and regulate the investment in these zones has been delegated to the IRS, who have done so in section 1400Z-1 and 1400Z-2 of the Internal Revenue Code. This section will offer a detailed analysis of these sections of the IRC regarding investing mechanics, eligibility, safeguards, and interactions with other parts of the tax code.

***Eligibility***

The concept is simple. A taxpayer can take their unrealized capital gain from the sale of a multitude of assets, be it stocks, real estate, a business, etc. and defer and possibly exclude their capital gains tax by putting that investment to work in a Qualified Opportunity Zone. Eligible taxpayers include individuals, corporations, estates, investors in REITs[2], or any taxpayer with a Federally eligible gain. In order for a gain to be eligible for these incentives, it must be treated as capital for Federal taxation purposes. This means the gain must come from the sale of a capital asset, with the exception of gains arising from Section 1231 assets.[3] Interestingly, these gains are considered capital for the purposes of QOZ investing even though the assets themselves are not considered capital assets. This exception posits QOZs as an alternative for real estate developers to Section 1031 exchanges (the advantages of which will be explored later).

[2] REITs as an entity are already corporate tax free
[3] Section 1231 describes tax treatment for the sale of real estate used in a trade or business

To invest an eligible gain in one of the 8,762 QOZ census tracts around the country, The IRS' rules mandate that an individual or entity must invest all or some of that gain into a Qualified Opportunity Fund within 180 days of sale of the original asset. Only gains invested in a QOF are eligible for preferential treatment (i.e. investing $80 of a $100 capital gain only provides the step up in basis on $80, not the full $100). QOFs serve as the sole investment vehicle available to take advantage of the tax benefits offered with Qualified Opportunity Zones.

Eligible gains qualify for a maximum of three potential tax incentives: deferral, a step up in basis, and exclusion. In order to qualify for any of these incentives, investors must invest their capital gain into a Qualified Opportunity Fund, which is the investment vehicle of QOZs, within 180 days of realizing the gain.

***Incentive Structure***

**Deferral.** The first tier of incentives is deferral of that gain until April of 2027 as long as the asset is held by the investor in a QOF until December 31st, 2026. The gain once again becomes taxable after December 31st, 2026 or if the interest in the QOF investment is sold before that date.

**Step up in basis.** The second tier of incentives come in the form of steps up in basis. Investors who invest their gains in a QOF at least five years before December 31st, 2026 receive a 10% step up in basis on their original capital gain. Alternatively, investors invest their gains at least seven years before year end 2026 receive a 15% step up in basis on the original gain. Thus, on a $100 capital gain from the sale of a stock, only $90 would be taxable at the capital gains rate if invested in a QOZ five years before year end 2026. Moreover, only $85 of that $100 would be taxable if invested in a QOZ at least seven years prior to the aforementioned date. When this example is put on a scale of millions of dollars, it becomes clear that entirely shielding

10-15% of a multimillion capital gain from tax is incredibly lucrative. Note that this does not apply to the gain on the QOZ asset itself, but rather the gain on the original investment.

**Exclusion.** The third tier of incentives is exclusion. If a QOZ investment is held for at least 10 years from December 31st, 2019, an investor is able to exclude all the gain accrued from the appreciation of the QOZ asset, in addition to the deferral and 15% step up in basis from the original asset's capital gain. This is investment strategy allows for the most robust incentives, allowing investors to enjoy all three tiers. Naturally, the longer the holding period (and therefore the earlier the investment), the greater incentive.

**Incentive Design.** The program is intentionally designed this way in order to encourage early and long-term investment in order to promote the spirit of the program. Systematic change catalyzed by private investment that transform blighted communities cannot occur overnight. Therefore, in order for the program to actually succeed in achieving Parker's original vision, investments need long holding periods. If the program allowed investors to invest in these communities, enjoy preferential capital gains treatment, and then retract the investment in a shorter timeframe, it would likely further exacerbate the problem of blight. A rapid injection of capital followed by its sudden disappearance can fracture a community for decades, akin to an accelerated rust belt phenomenon (Jia 2008). This sort of maneuvering of capital in and then quickly out of Low Income Communities (LICs) across the country would be incredibly exploitative. The media would lambast the program as a heist by wealthy investors of tax revenue at the direct cost of some of America's poorest communities. The ideological divide between rich and poor America would grow tenfold and any future attempts at such a program would be nixed. For this reason, it is imperative that these holding requirements are in place to safeguard an abuse against the spirit of the program.

***Safeguards***

**The 90% Test**. In order to verify that a QOF is investing properly and not misusing its designation, 90% of its assets must be held in a Qualified Opportunity Zone Property (QOZP), a benchmark which is tested in six months intervals. A QOZP can either be a subsidiary stake in QOZ Stock or partnership/corporation that conducts business in a QOZ (known as a QOZB) or a Qualified Opportunity Zone Business Property (QOZBP). QOZBs can operate directly or be indirectly organized as either a partnership or an S or C Corporation. Alternatively, a QOZBP is the tangible real property itself. Though the establishment of QOZBS present unique opportunities to enhance the community in QOZ tracts (particularly through resident ownership), their regulations and the study of their efficacy is outside the scope of this paper. Instead, the focus will primarily be on QOZBPs as they directly involve the properties and land located in QOZs and their potential redevelopment. These different asset designations provide a large degree of flexibility in terms of how a QOF chooses to put its investment to work. Regardless of how the QOF classifies and invests its capital, the 90% test applies universally. This test can be conducted either through financial statement analysis of the book value of the property (after depreciation and amortization) or through alterative valuation based on the cost basis of the property (Azar, 2019).

**Original Use Qualification.** For real property in a QOZ to qualify for preferential gains treatment it must qualify as a QOZBP. To do so, the IRS mandates that the property in question must have been purchased after 2017 from an unrelated party and that the property have an "original use." An original use of a given property in a QOZ commences with the establishment of QOZB or when the QOF/QOZB "substantially improves" the property. Original use occurs when the property is placed into service for the first time for the purposes of depreciation and/or amortization.

Additionally, placing property that has sat vacant for five years or more (or for three years after its tract was designated as QOZ) back into service qualifies as original use. Substantial improvement is measured by level of investment in the QOZP. It occurs when a QOF at least doubles the adjusted tax basis of the property from the time of acquisition over the course of 30 months, beginning at the discretion of the QOF. Essentially, these provisions exist to safeguard against investors buying QOZ properties, operating them status quo, and selling them in 10 years thereby enjoying the appreciation of the property while taking advantage of exclusion and a step up in basis from the gains of a prior asset.

An investor must provide value to the QOZ and improve the community. The IRS regulations accompanying Internal Revenue Code (IRC) Section 1400Z-2 are careful to maintain the spirit of the law and ensure that all QOF investment activity is value-add. Regulation Section 1.1400Z2(f)-1 details a scenario wherein an investor paves a vacant lot as a parking lot, adds several jobs for attendants and then sells the asset after 10 years to capture the exclusion provided from the program. The IRS regulatory language (2019) explicitly forbids investment

> Carried out to achieve a tax result that is inconsistent with the purposes of section 1400Z-2 and the section 1400Z-2 regulations. Consequently, the land is not qualified opportunity zone business property and gain from the sale of the land will not be eligible to be excluded from gross income.

Despite the clarification in this regard, many questions remain as to what constitutes original use and substantial improvement. Forbes Economist Anthony Nitti presents a quandary left unanswered by the original law and all three rounds of regulatory guidelines, “what if a taxpayer buys a building that is 97% complete, puts on the finishing touches, and places it into service for the first time? Is the original use test met?" (Nitti, 2019). The Second Tranche Regulations (2019) seem to suggest that as long as a building under construction is acquired before its placed in service, it qualifies as original use. Though a rare scenario, the ambiguity around such situations have investors feeling skittish.

The inherent riskiness of these investments makes qualification as a QOZBP a critical component in ensuring that such deals pencil. After all, if the entire point of O-Zones is to facilitate investment that would otherwise not be feasible, any ambiguity around regulatory compliance necessary for the coveted tax incentives will scare away rational investors.

## Interactions with the Other Parts of the Tax Code

### *The Section 162 Problem*

After qualification as a QOZBP is established, investors must operate the property in compliance with the regulations for QOZBPs in order to maintain that status throughout the duration of the investment holding period. One of the most glaring concerns for QOZ real estate investors is that QOZBPs are required to be operated as a Section 162 trade or business. Essentially, this is another safeguard to ensure that real businesses that will impact the community are being ran in QOZPs, which is necessary to uphold the spirit of the law, however, it poses particular problems for investors looking to establish multifamily syndication as a QOZBP.

The Second Tranche Regulations confirm that ownership and operation of real property is an active business activity pursuant to Code Section 162, even the management of such is conferred onto a property manager (De Kuiper et. al., 2019). However, the IRS historically treats rental property ownership conducted on a Triple Net basis as an investment rather that

Section 162 business (Nitti 2019). Section 1.1400Z2(d)-1(3)(A)(ii) (2019) affirms this assessment and states that “merely entering into a triple-net lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business”. Since the IRS did not provide an exemption for rental properties using an NNN lease structure, such use will fail to qualify as QOZBP and thus not be eligible for the tax incentives.

It appears the main concern of the IRS is the lack of risk for an investor that secures a long-term NNN lease with a credit worthy tenant and is then able to ride out the 10 year holding period with minimal risk and exit the position as soon as the tax benefits are realized. Triple-Net leasing is a staple for landlords across multiple product types, particularly office and retail users. This regulation poses a serious problem to the fundamental enhancement of these communities, as these products types will be critical in aiding in the improvement of QOZ communities through their job creation product type. While this will discourage some investment, the clarification that the operation of real property is a valid Section 162 use is critical in ensuring the development of affordable housing in these LICs.

### ***Differences with a 1031 Exchange***

Given this paper’s focus on real estate investment, it is worth investigating how QOZ investing compares with another part of the Tax Code and one of the most common industry tools for deferring capital gains tax on the sale of a property, an IRC Section 1031 Exchange. Both reinvestment approaches offer a means of capital gains deference, with their main variation being the scope of the reinvestment. Whereas like-kind (1031) exchanges are limited to swaps of real estate to real estate, QOZ investment can come in the form of capital gain reinvestment from any qualifying capital asset (including, but not limited to, real estate) and can be spread across multiple assets through the QOF pooled structure.

Capital gains deferral through like-kind exchanges can be deferred until the sale of the replacement property – effectively indefinitely (hence the "swap 'till you drop" idiom) while capital gains reinvested in a QOF come due in April 2027. In exchange for the shorter capital gains deferral period, QOZ reinvestment offers a 10-15% step-up in basis on the original gain (depending on when the reinvestment occurs) while a 1031 Exchanges only offers a step-up in basis upon death (Levine & Segev 2019).

QOZ investment significantly outperforms 1031 Exchanges in that a QOZBP held for 10 years or more can exclude capital gain on the appreciation of the QOZ asset. In a 1031 scenario, after the eventual sale of the asset (regardless of how many swaps occur), capital gains from the new asset cannot be excluded. 1031 Exchanges offer investors a lower cost alternative to gain reinvestment than QOZs. An investor can swap properties without necessarily incurring large capital expenditures each swap by swapping for turnkey properties. Conversely, in order to receive the preferential gains treatment, QOZ properties must be substantially improved either through ground up construction or massive value add projects that double the original cost basis of the property.

1031 Exchanges also benefit from the maturity of their industry which has streamlined the process and created a large market to facilitate swaps with ease. QOZs are an infant industry that is not well understood and requires heavily monitored compliance to a plethora of new and sometimes ambiguous regulations (Pessar 2019). For this reason, using a QOF as an instrument for capital gains deferral will likely be ignored by investors comfortable with the 1031 system until the QOZ system builds enough momentum from an institutional players.

The issue with this rate of adoption is that O-Zones expire at the end of 2026 and the first wave of investment (and thus the opportunity to fully exclude gains on the appreciation of a

QOZP) has passed. While QOF investing is more versatile and lucrative in its scope and incentives than the rigid structure of the 1031 program, its relative complexity and novelty will likely outweigh its benefits over 1031 exchanges in the minds of average investors. Though QOZs may only draw the more speculative ilk of real estate investors away from like-kind Exchanges, it will have broader appeal to investors outside the real estate industry. Given its broader scope that allows for deferral of gains from any capital asset and subsequent reinvestment into a QOF with an array of investment options, O-Zones should draw interest from private equity both within and outside the real estate industry.

## Efficacy Analysis

### Trump's Promise

Now that this paper has intimately explored the fundamentals of Opportunity Zone investing, it is crucial to analyze the program's performance to date. In his 2020 State of the Union Address, President Trump touted

> Jobs and investments are pouring into 9,000 previously neglected neighborhoods thanks to Opportunity Zones…In other words, wealthy people and companies are pouring money into poor neighborhoods or areas that haven't seen investment in many decades, creating jobs, energy, and excitement. This is the first time that these deserving communities have seen anything like this. It's all working.

While the full impact of the program cannot be realistically assessed until the expiration of QOZs at year's end in 2028, early indicators can be used to predict future success. Given that the December 31st, 2019 deadline for the first round of investing recently passed at the time of writing, a picture of how investment will manifest has begun to emerge. Since the recent deadline was investors last chance to enjoy the threefold preferential gains treatment that includes exclusion, there is good reason to believe that a sizable portion of the total QOF investment would want to have invested this cycle. As the Joint Committee on Taxation (2017) found that the QOZ program would be a 10.6 billion tax liability over the next 10 years, it seemed incredibly prudent to see what results the program has yielded to date. With this understanding in mind, I set out to test whether President Trump's assertion was true; whether there really was a massive influx of capital pouring into these census tracts.

## Early Investment Concern

### *Current Criticisms*

Before exploring proprietary analysis, it was necessary to understand current public perception of the program's efficacy. Despite the fact that the program is in its infancy, there is widespread reporting that QOFs are desperate for funds and the program has failed to excite investor capital. This is an important criticism to investigate as the Joint Committee on Taxation (2017) found that the QOZ program will be a $10.6 billion tax liability over the course of its life. Since QOFs have no reporting requirements, it is difficult to know the realistic nature of the initial investment expectation of $100 billion (Herschmeyer 2019). Of funds that reported to the SEC, CoStar (2019) found that only 3 billion was raised in 2019, however there was a significant increase toward the back half of the year as the investment deadline approached. This statistic is not particularly helpful as many funds have not reported, but there is reason to believe this program will continue to drum up capital from investors.

Foremost, there has been a concerted effort of municipalities vying for these funds to pair the QOZ investment with other mechanisms. Stevenson (2019) finds that cities are attempting to pair OZ investment with other tax credits like Tax Increment Financing, NMTCs, and

Historical Tax Credits. Meanwhile cities like South Bend, Erie, and Louisville have released packages to woe investors to their cities' QOZs (Charles 2019).

***Potential for Increased Lending Volume***

Moreover, there is increasing reason to believe lenders will find QOZ deals more attractive as reform of the Community Reinvestment Act will allow banks to use the extension of credit to deals in LICs to fulfill their requirements under the act. CRA ratings are crucial for banks to be able to perform certain activities and directly affects their scores from regulators (Larsen, 2020). By incorporating OZ investment as a qualifying for credit under the CRA, lenders will likely flock towards these lending opportunities at a much higher rate, and deals that were otherwise passed on might receive a second look. As a result of this stipulation, QOZ investors like Shane Neman have found that "…private lenders and funds that are coming to me with loans that are beating the terms of regional banks, which usually give the best deals" (Larsen, 2020). With this combination of factors working alongside the incentives already in place, it is difficult to imagine that investment will not exceed the $10.6 billion tax liability after all three deadlines have passed.

**Methodology**

With that general consensus in mind, I began my own analysis. To assess the efficacy of the program in attracting private investment to QOZs, I compiled raw data from the CoStar Group, a comprehensive real estate service that extensively tracks properties, property sales, construction, leasing, capital markets, and rental information from properties around the country. Using CoStar's data analytics tool, I was able to aggregate data from all 7,826 Opportunity Zones Census Tracts located within the 50 States and D.C. (data from the 938 Census Tracts within the five American territories was not available). The focus of this data collection was on the multifamily market, though some national data was collected on other product types. As manual data collection is cumbersome, only one product type could realistically be examined at any meaningful level of detail. Multifamily investment was chosen at the primary lens through which to analyze QOZ efficacy because of the inextricable link between affordable housing and poverty alleviation.

Currently, our nation faces an affordable housing crisis. The National Association of Realtors (2019) reports that the number of homes for sale at the end of November 2019 was the lowest ever recorded. Most notably, housing inventory available for under $100,000 was down 15%. A cause and a symptom of this data, is that more people are forced to turn to renting and delaying home ownership. But renters face this same affordability crisis. Pew Charitable Trusts (2018) found that in 2015, 38% percent of American renters were rent-burdened (spending more than 30% of their pretax income on rent), representing a 19% increase from 2001. Within that statistic, 17% of renting Americans are severely rent burdened (spending 50% of pretax income on rent). This phenomenon has hit minority community the hardest, with 46% of African-American renters being rent-burdened. These statistics demonstrate the grim affordable housing crisis in this country, which is driven in large part by supply constraints. Housing is the foundation of any community; a neighborhood cannot exist without its residents. Thus, it logically follows that the quality and amount of housing stock has to improve before other community institutions can feel the impact of revitalization. Given this reality, multifamily investment was chosen as the most critical data to analyze within QOZ tracts as an indication of whether communities are going to trend away from blight.

Within the 7,826 tracts analyzed, there are 103,489 existing multifamily properties. Looking at the data from all those tracts and properties as a whole, I gathered information about total construction starts from Q2 of 2017 until Q2 of 2020 and the total annual sales volume from 2015-2020. In addition, I recorded changes from 2017Q2 to 2020Q2 in the average capitalization rates, vacancy, absorption, and asking market rent. Next, I collected this same data from the Opportunity Zones within each of country's 50 most populous Metropolitan Statistical Areas, based on rankings in the July 2019 Census Bureau data. Together, this information gave me comprehensive data to analyze trends in QOZs at a national level, a municipality level for each of the 50 biggest MSAs, and at a "rest of country" level for all the QOZs outside those 50 MSAs. All data is accurate as of April 26th, 2020.

## Multifamily Investment Increase: Construction

### *Data Results*

Using this data, it is was first important to understand whether investment had increased at all in these tracts since their designation as QOZs. For the purposes of this analysis, investment is measured in terms of change in the amount of multifamily units under construction at any given time from 2017Q2 to 2020Q2 and in total sales volume of multifamily properties each quarter from 2015 to 2020. These timeframes allow for an analysis of multiple quarters before the QOZ tracts were finalized in the waning days of 2018Q2 as a means to see whether increases/decreases in investment are based on trends that predate OZ designation.

Beginning with construction, Figure 1 shows that in Opportunity Zones nationwide showed a 40.48% increase in the amount of units under construction from their pre-designation levels in 2017Q2 to 2019Q2. This increase is 24.71% higher than the national construction average. This strongly suggests that QOZ designation has spurred multifamily construction activity in these communities. However, Figure 1 reveals that the vast majority of this new construction is occurring in the top 50 MSAs of the country.

Even more striking is that the percent increase decreases for each expansion of cities outside the top 3 MSAs. This phenomenon suggests that construction is concentrated in the country's largest cities. Indeed, the data seems to confirm this suspicion as OZs outside the Top 50 MSAs have experienced a smaller increase in construction than the national average. In other words, OZs outside the nation's biggest cities are underperforming national construction trends despite their sweeping tax incentives.

This result is disappointing but not unanticipated. Sean Parker himself noted that the structure of the O-Zone program lends itself to a "herding mentality and a domino effect…The more momentum an area gains, the more investors it will attract" (Bertoni, 2018). This data suggests the emergence of such a domino effect in America's largest cities, which in many respects strays from Parker's original visions for the program. Though the country's biggest cities also have blight and areas in need of revitalization, one of the main concerns that drove the

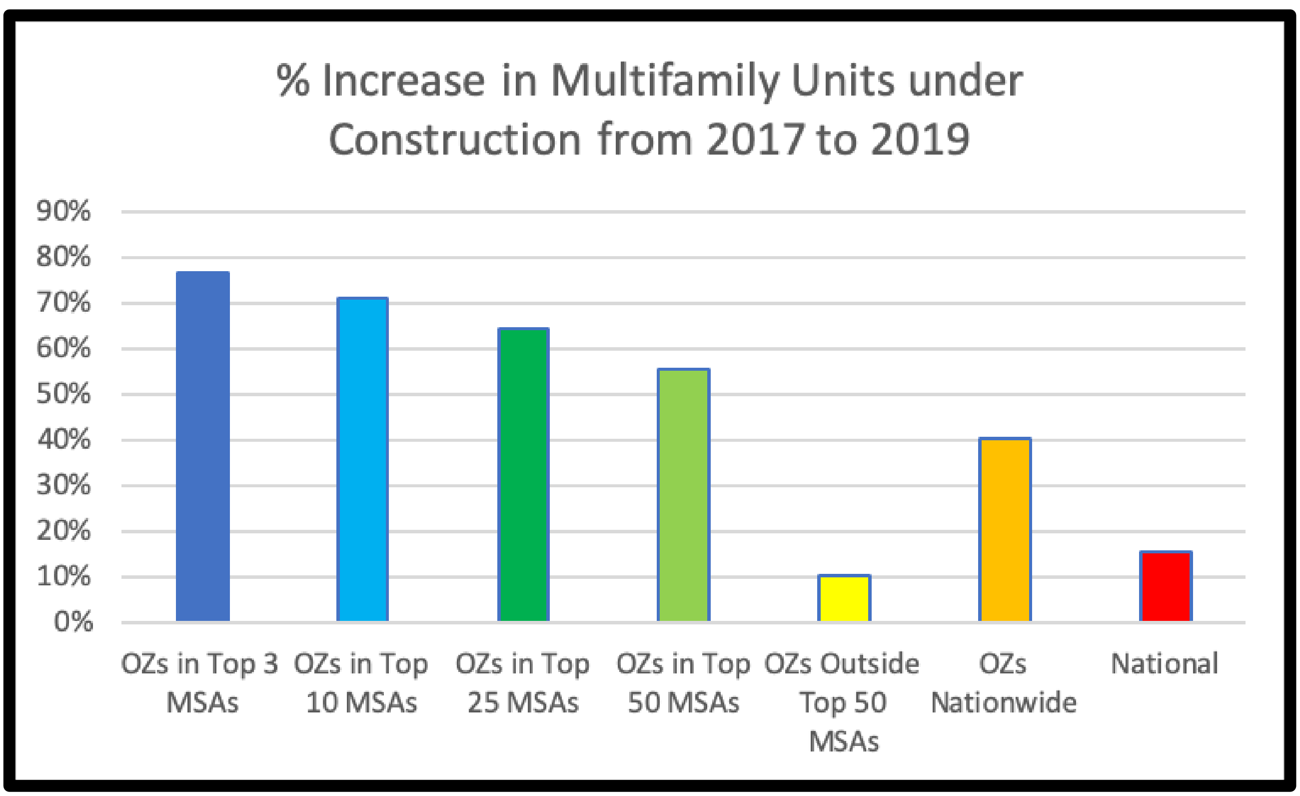


**Figure 1**

innovation of OZs was to remedy the investment disparity between coastal economic hubs and struggling cities.

Figure 2 reveals that the correlation between city size and investment levels are largely consistent, with the peculiar exception of the Top 41-50 MSAs. However, this data is somewhat misleading a as almost half of those 10 metro areas saw negative growth (Oklahoma City, Raleigh-Cary, Louisville, and Hartford) while the four of the other six saw over 100% increases in growth (Birmingham, Buffalo, Memphis and New Orleans). Most notably, OZs in Birmingham went from 0 units under construction to 844 in that two year time frame. As you can see, grouping by size alone provides insight as to the general trend toward investment in larger cities, but does not show the exact relationship between amount of Opportunity Zones and percent increase in construction. OZs were not necessarily proportionally nominated by governors and then allocated by the Treasury Department in such a way that a city's size guaranteed it more zones.

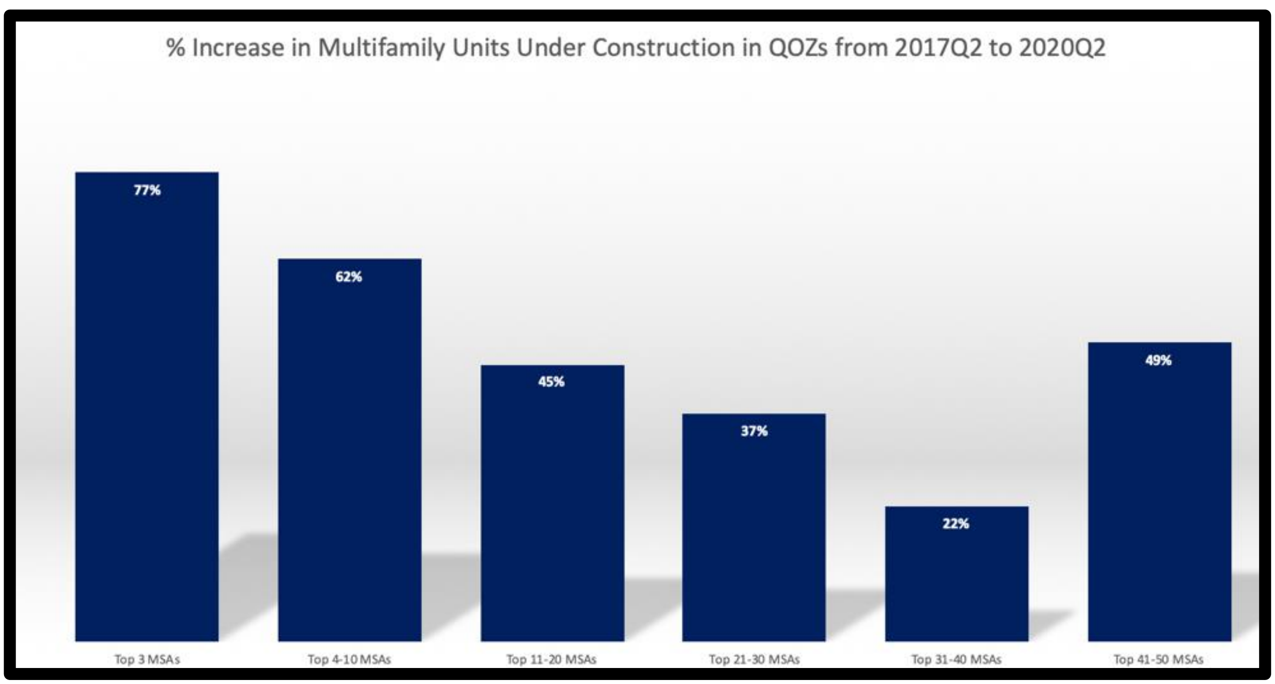


**Figure 2**

The scatterplot in Figure 3 shows the correlation between the amount of QOZs in an MSA and the increase in the number of units under construction in those tracts from 2017 to 2019. This is perhaps the most useful data as it shows the direct relationship between QOZ designation and unit construction. The linear relationship yields an R-Squared value of .5413, or a Pearson's Correlation Coefficient of .7357. This PCC shows that there is a strong positive correlation between the two variables, suggesting that the more Opportunity Zones an area has, the larger increase in multifamily construction it saw from 2017 to 2019.

Of course, MSA size does not tell the whole story of the impact of QOZ designation on multifamily construction. Grouping by geographic area reveals more trends about how equitable the distribution of investment has been thus far. After all, real estate is a field entirely predicated on location. Figures 4 and 5 show percentage increase in multifamily unit construction in QOZ tracts within the Top 50 MSAs from 2017 to 2019, grouped by Census-Designated Regions and Divisions. The data here clearly shows construction increases across the board after QOZ designation, with a particularly robust increase in construction in the Upper Midwest. This distribution suggests a number of possibilities.

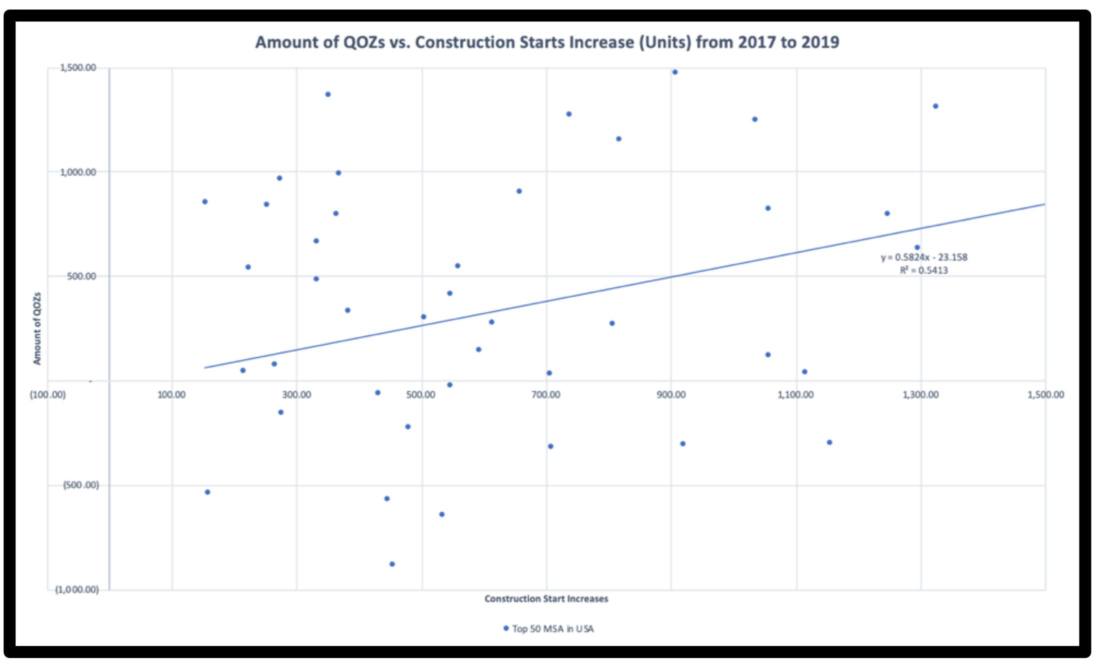


**Figure 3**

***Data Explanations***

One such possible explanation is that the region showing the least construction growth, the West, is dominated by large, financial hubs that feature cities that are already built up. California alone is home to 10.6% of the Fortune 500 companies and faces an affordable housing crisis. California, which comprises 6 of the 12 MSAs included in the "West" dataset, has a much

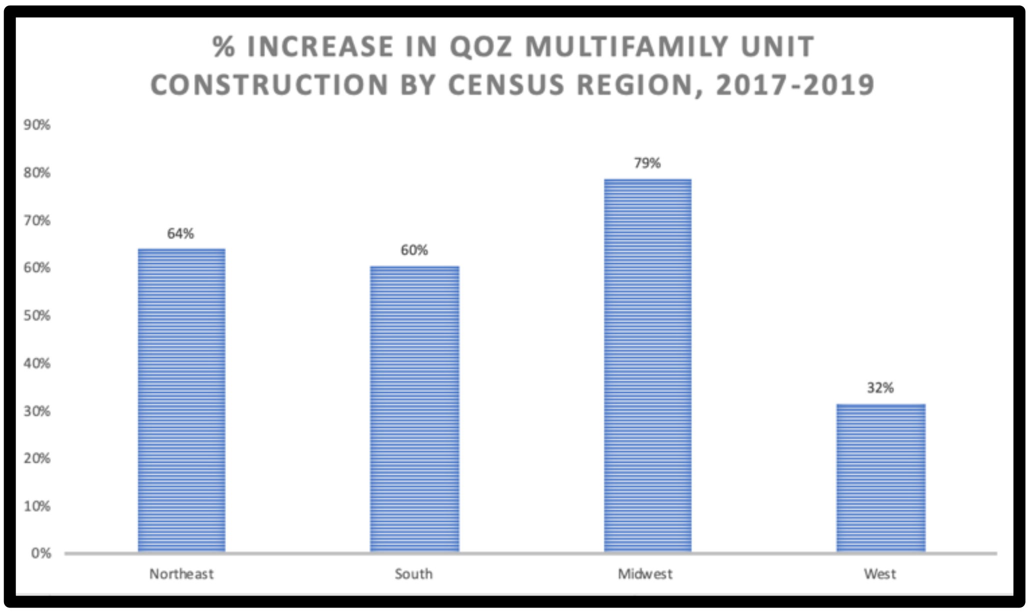


**Figure 4**

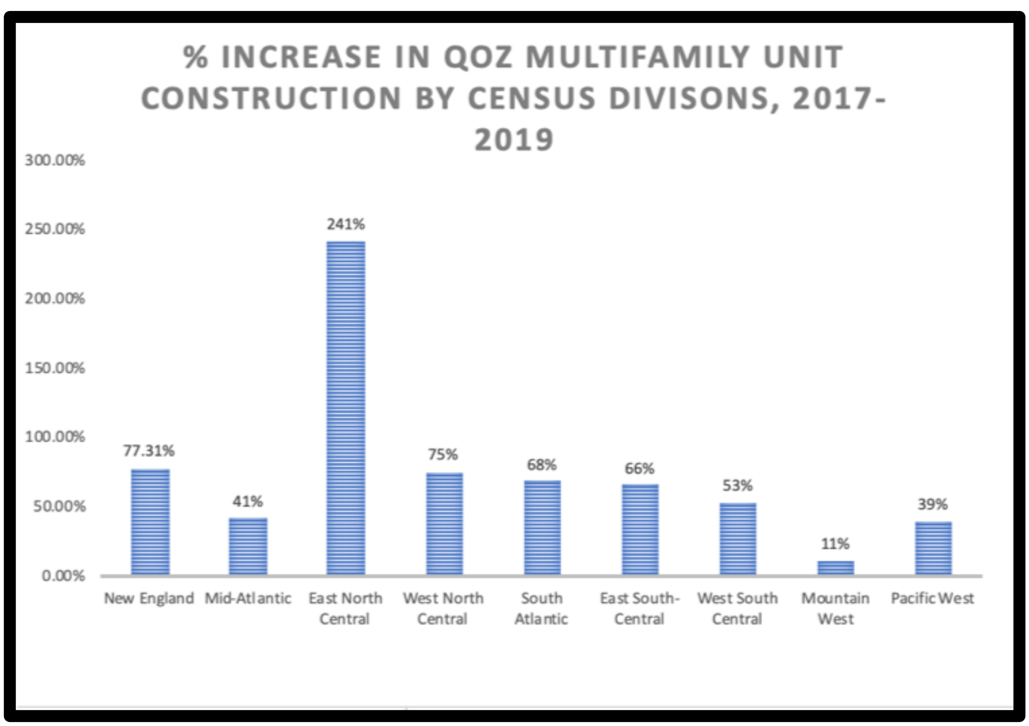


**Figure 5**

higher percentage of infill development than most other areas of the country because its largest metros have spatial constraints. In addition, new construction in California has a much longer predevelopment period due to a lengthy entitlement and community review process enabled by the California Environmental Quality Act. Reid and Raetz (2018) found that in San Francisco, almost 80% of construction projects take longer than 3 years to complete. In addition, they showed that construction in California is incredibly expensive, with average cost of $330 per square foot in San Francisco, the second highest in the world. Though the Bay Area is extreme, similar problems plague new development across California.

At the same time, another possible explanation is that markets in the Midwest are positioned diametrically opposite. The CoStar data set shows vacancies are historically higher and rents are lower. In addition, construction costs are lower and regulations are less severe. In other words, development is a smoother process on balance. Couple these facts with the reemergence of the Rust Belt, and these cities become prime examples of what Senator Cory Booker calls “Domestic Emerging Markets”, ripe for business and investment (Bertoni 2018). Duval (2019) contends these “emerging market” in QOZs will directly compete with foreign emerging markets for capital investments in businesses because they afford domestic convenience at foreign cost of capital.

There is plenty of reason to share that optimism. Across the Rust Belt, abandoned factories are being converted to trendy mixed-use apartments and formerly dormant downtowns are garnering national praise. Downtown Cleveland’s occupancy rate has creeped upwards of 90% as young professionals looking for cheap urban living migrate to the Upper Midwest (Milligan 2014). Grosvenor (2014) ranked Pittsburgh the number five most-resilient city in the world for commercial real estate investment. Countless other examples of the Rust Belt’s reemergence have been chronicled over the last half decade. Combining this trend with the tax incentives offered by 579 census tracts across the area's largest metros explains the increased propensity of investors toward this region.

## Existing Multifamily Acquisition

### *Data Analysis*

New construction is only one half of the equation comprising multifamily investment. In many cases, investors will be looking to substantially improve one of the 103,489 existing multifamily properties in QOZs. The CoStar Data in Figure 6 shows that multifamily sales volume in QOZs has generally grown over the last five years, with the nation overall peaking in 2019, a trend followed by most markets. This intuitively makes sense and follows the nation's overall upward multifamily trend, with an almost 16% increase in sales volume from 2018 to 2019 (Newmark Knight Frank, 2020). From this data it is difficult to ascertain whether the growth is due to overall multifamily trends or QOZ designation.

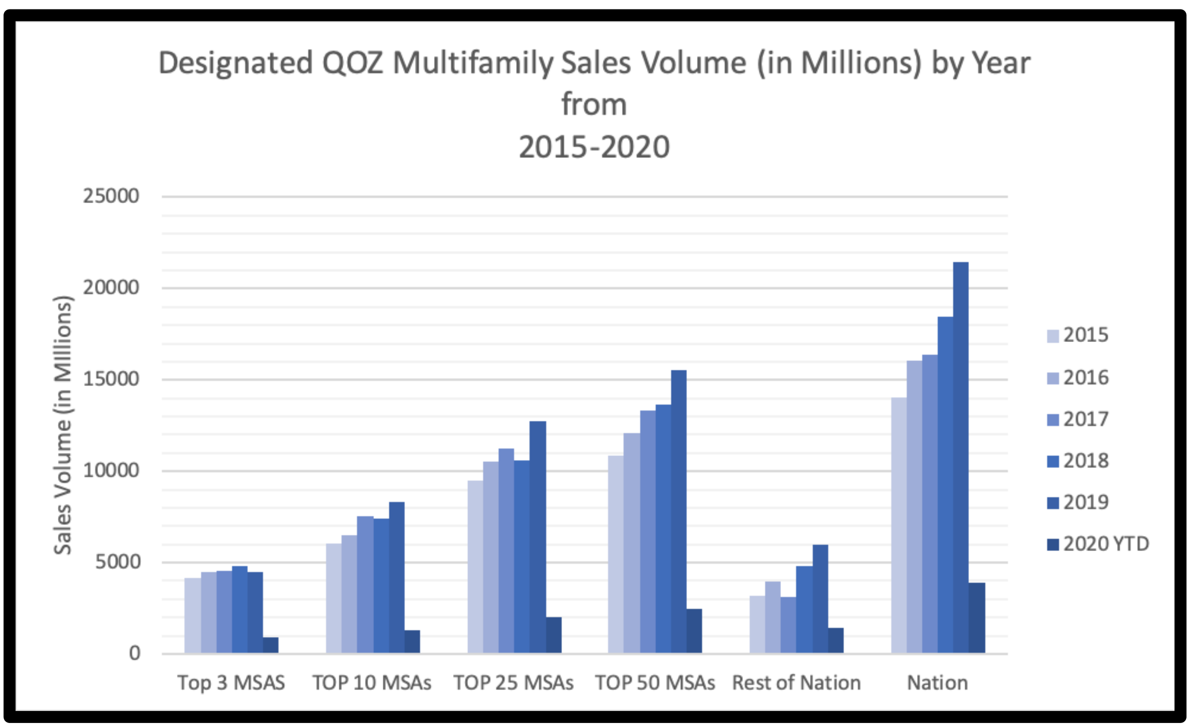


**Figure 6**

Figure 7 offers a closer look at the markets by relative size, showing encouraging signs. This data suggests a more equitable distribution of investment across America, with a particular increase in the concentration of sales volume across midsize metros and micropolitan areas. To further this point, simple linear regression shows a 13% correlation between amount of O-Zones properties in an MSA and the increase in the total dollar amount of sales in that metro from 2017 to 2019. This weak positive correlation suggests that the more opportunity zones an area has does not mean it will see a larger increase in investment. One possible explanation lies in the fact that overall multifamily sales volume has grown from 2017 to 2019. Newmark Knight Frank's *4Q19 Multifamily Capital Markets Report* shows that multifamily sales volume have grown between 18-19% in that time frame, which is over 12% less than the nationwide QOZ growth rate shown in Figure 7. Keeping in mind the low correlation and the fact that the CoStar data shows an overall QOZ sale volume increase greater than the national non-OZ average, it follows that investment must be increasing more in smaller metros with less QOZ properties.

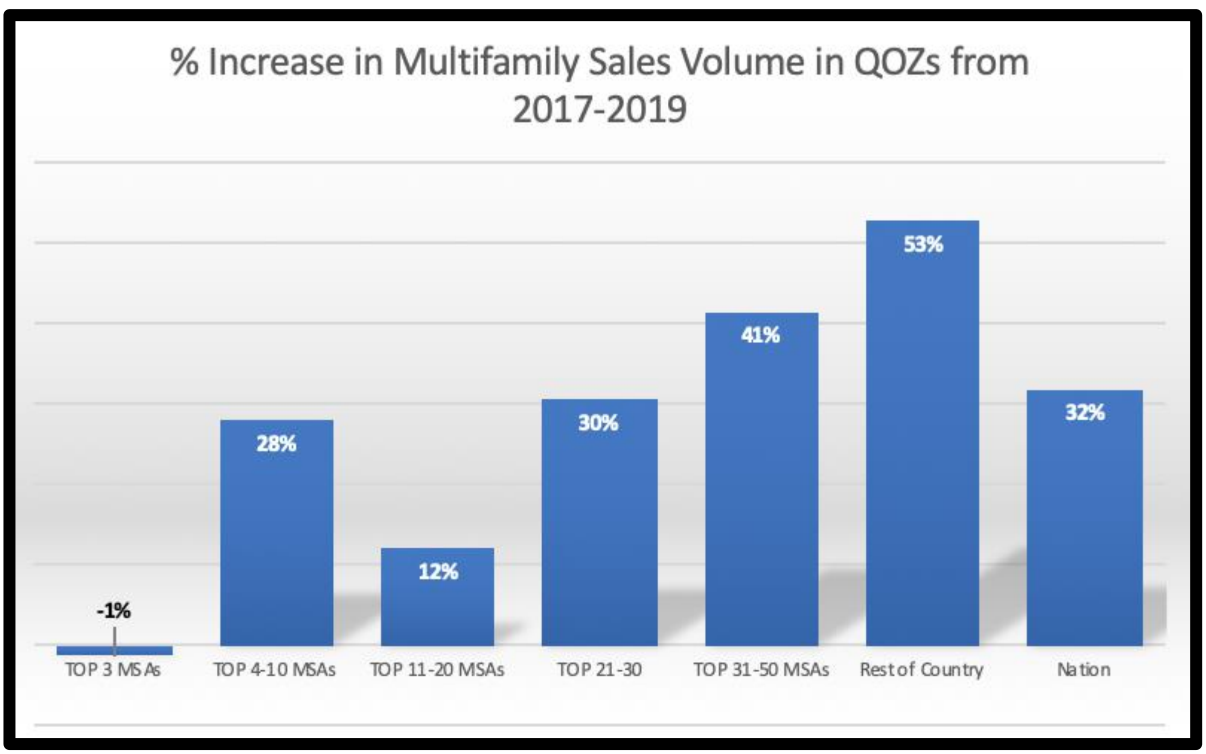


**Figure 7**

This is one of the most encouraging developments in the early QOZ capital markets data, as it shows the program directly responding to the problems that sparked its creation.

***Geographic Explanation of the Data***

Parker's main motivation for innovating the program was in response to the geographic disparity in economic recovery from the Great Recession. Parker predicated the creations of these zones under the impression they would excite capital in areas that otherwise would not a second look. Oklahoma City Mayor David Holt summarized this idea, "So maybe people look at the best deal in OKC and invest here instead of the 200th best deal in Los Angeles" (Charles 2019). Holt may get his wish; the data in Figure 7 suggest that acquisitions of existing properties in QOZs are growing at a faster rate in smaller metros than in America's largest cities. In fact, America's three largest MSAs actually saw a nominal decrease in the sales volume of QOZ properties since the program's announcement. Though a myriad of factors may contribute to this data, it is reasonable to assign some of this increase to the OZ designation.

**Impact on Capitalization Rates**

While construction numbers and sales volume can suggest an increase in activity in an area, this activity can have a negligible impact on improving a community unless it actually adds value. To try and understand the impact of QOZ designation on a community, I analyzed the change in multifamily capitalization rates from 2017 to 2020. As shown in Figure 8, all four Census Designated Regions showed cap rate compression of at least 11 basis points above the national non-QOZ average from 2017-2019. Moreover, the average compression of cap rates for the Top 50 MSAs was more than double the national non-OZ average (.29% vs. .12%). As a reminder, cap rates are derived from the division of a property's Net Operating Income by its value. Compression of these rates can result from three scenarios. There can be a decrease in the numerator (NOI), an increase in the denominator (value), or a combination of both.

Given the general nature of multifamily QOZ properties as being blighted or even vacant, they are largely non-revenue or low revenue performing to begin with. Though this is a generalization, it is difficult to imagine that there was a widespread decrease in income in these properties given both the overall trend of the economy from 2017-2020 and the ratio of demand to supply in the housing market. Thus, the more likely cause of this compression is an increase in value. This is perhaps the most exciting bit of early data garnered from this process, as it directly translates into an increase in the value of blighted properties in these communities.

Though lots of this value appreciation may be due to speculative buying, it is nonetheless an encouraging sign. Moreover, Sage (2019) found no evidence of an expectation effect artificially driving up value in QOZs. Unlike value appreciation that occurs with other assets like stocks, the nature of this program largely insulates against this value being artificially

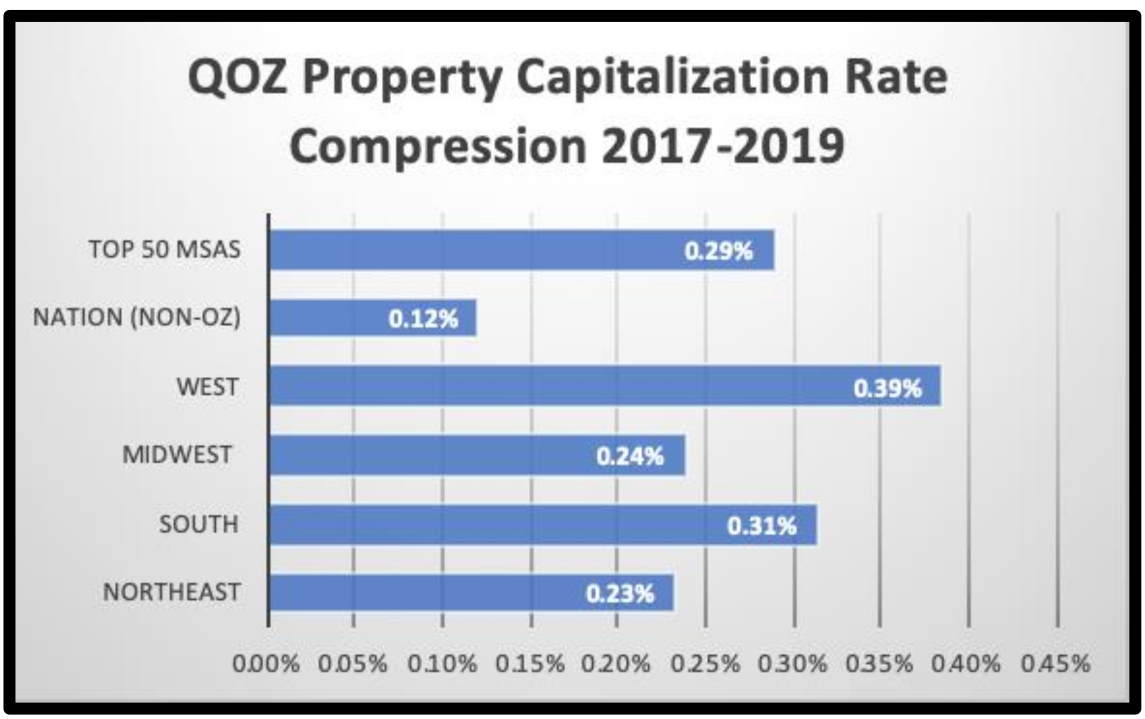


**Figure 8**

inflated. The program has specific investment deadlines and holding requirements in order to enjoy the tax benefits. Therefore, there cannot be an endless cycle of buyers and sellers until the speculative bubble pops. Thus, this value appreciation is not temporary and will likely only rise as these properties are improved under the requirements of the program.

The data in Figure 8 suggests the largest compression is occurring across the West and South. This is largely consistent with the overall rapid appreciation of value across the sunbelt, which is then only accelerated by the effect of OZs. Nonetheless, OZ properties in every region of the country have compressed by nearly double the national rate, at a minimum. This increase in property value above the national level suggest an overall uplifting of these communities values that will be crucial in attracting further non-QOZ driven investment. Ultimately, this is the end goal of the program. By attracting enough capital to blighted, poverty-stricken areas with tax incentives, the community will hopefully cross a threshold and reach a point where it can attract private investment without the need for added incentives.

**Overall Data Takeaways**

When analyzing the CoStar Data as a whole, several large-scale trends can be observed. First, it is clear that overall multifamily investment has increased above the national level in Opportunity Zones from 2017-2019, whether that be in construction or sales volume. Costello (2019) corroborates these findings by showing almost 30% year over year growth in overall OZ transaction volume (all product types). More specifically, the data reveals that bigger metros are attracting the most new QOZ construction while mid-size metros are attracting the most acquisition of existing QOZ properties.

Though the construction and sales volume data tell very different stories, they are largely inverted. QOZs with strong construction have lower sales volume increases, while QOZs with high sales volume have experienced less construction. This suggests an equitable level of investment across the nation, just taking the form of the most prudent method for each area. Geographically, the data shows the largest increase in multifamily construction across the Upper Midwest, which is consistent with the urban revival of the Rust Belt over the last decade. Meanwhile, value increases indicated by cap rate compression were most noticeable in the Sun Belt. Overall, QOZ designation has increased the value of properties in QOZs by at least double the national growth rate in every region of the country. Ultimately, though this investment has taken different forms in different areas and is not dispersed exactly equal across the country, the increase in QOZ investment has decidedly outpaced the average increase in investment in that time period. For these reasons, the early indicators suggest that this program has had a tangible effect in exciting investor capital.

**Conclusion**

The Qualified Opportunity Zone program remains a divisive program in the world of real estate development and urban planning. Though many community leaders like Marlene Cintron have already written off this program, the reality is that this program has just now started to get underway. The idea that Federal programs like this will provide instant remedies to issues like urban blight is misguided. The Opportunity Zone initiative is inherently designed to promote long term capital holds in distressed areas. The first of three investment deadlines passed only five months ago, and it will take years for construction and value-add property rehabilitation to occur, and even longer after that for the byproducts of that investment to be felt in terms of overall community enhancement.

Indeed, Blake (2020) reports that the first QOF funded, ground up multifamily construction just broke ground at the beginning of the year. This process will take time. One of the most beautiful features of real estate development is its physical impact on the urban landscape. Development has the power to completely alter and redefine a neighborhood, both aesthetically and in its character. But this is not an overnight process. Even if a new mixed-use apartment-retail complex is built in a blighted neighborhood tomorrow, it will not solve that area's problems. No singular project or level of investment has that power. Rather, the natural coalescence of investment across many years will work to erode the underlying issues.

Apartment buildings increase the stock of housing and help alleviate the supply constraints that drive the affordable housing. New retail provides jobs and leisure to an area. People want to be able to shop and relax in their own neighborhoods. Office provides new jobs which in turn drives demand for more housing options, retail, and community amenities. Slowly, as all these forces overlap, blight disappears. This is the reality that OZ critics fail to see. QOZs are not just a windfall for rich developers; they are an investment in America's neighborhoods.

The classism that has entrenched the American worldview has twisted the framework of programs like this so that any gain for the rich must be a loss for the poor. This does not have to be the case. Opportunity Zones do not need to be a zero-sum game. They can be both incredibly powerful tools for investors while also laying the foundation for community revitalization. Indeed, O-Zones should not be thought of the harbinger of revival but rather as a tool towards remedying the woes of blight.

At the end of this program, even the QOZs that experienced the heaviest levels of investment will not be blight-free. At best, QOZs should probably be used as a tool to make a community attractive enough to warrant consideration from other investors who will slowly bring the community new life over the course of decades. If QOZ investment can breathe new life into these communities, they will hopefully be able to gather enough momentum to excite capital without the tax incentives.  Despite the negative press, the undulations of the rollout, and the uncertainty, this program is by far the most innovative and potent program of its kind possibly ever conceived by the Federal Government.  In reality, the QOZ program cannot really not be holistically assessed until the end of the investment period and likely even some years after that.  Maybe investors will make out like thieves or maybe blight will diminish substantially in America's cities.  Maybe both will occur.

There really is little to suggest any particular outcome at this stage.  But if the early data is any indication, investment is up and investors are excited.  Whether Parker's vision comes together as he fantasized remains to be seen.  Until then, there's really no harm in rooting for the program to succeed.

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