HB 4010 – Oregon Disconnect from Opportunity Zones: Look Before You Leap

Background

An Opportunity Zone ("OZ") is an economically-distressed community where private investments, under certain conditions, may be eligible for deferral of capital gain taxes. OZ's were created to stimulate economic development and job creation by encouraging long-term (10 year) investments in areas with largely low-income residents.

Since the implementation of OZ's, many stakeholders have worked to understand the mechanics of these capital gains deferrals and the costs and benefits to the state based on this federal incentive program. Oregon is again considering disconnecting from the federal code (HB 4010). While the federal regulations were finalized in late 2019, both Republicans and Democrats in the US Senate have proposed changes to add oversight and protections to the OZ program.

How were Oregon's OZ's created?

The Federal OZ Program was created in December 2017. Governor Brown then worked with Business Oregon to identify and nominate Oregon's 86 Zones. Oregon's process for creating our rural and urban OZ's has been recognized as the best in the country. Smart Growth America's LOCUS program gave Oregon the best-in-the-nation score for identifying zones "positioned to bring positive social, environmental, and economic returns."

What are capital gains?

Capital gains are the positive difference between the sale price of an asset and its original purchase price. Federal and state taxes are levied on capital gains once (and only when) an asset has been sold and, as a result, the taxpayer has "realized" the gain in the form of income. Capital gains taxes can be avoided by holding an asset or, for real estate assets, exchanging that asset for a similar asset. Unlike income or property taxes, there is no certainty over when capital gains are realized and therefore may be taxable.

What are the benefits of Oregon's OZ's?

OZ's create an incentive for investors to invest capital in communities by allowing a deferral of the capital gains taxes. This encourages investors to re-deploy capital rather than hold assets to avoid being taxed. OZ's seek to seed capital in these disadvantaged communities through "Opportunity Funds." These funds hold newly acquired assets such as capital in a corporation or partnership, or in real-estate holdings. This facilitates investment in local businesses, as well as real-estate development, that spurs construction jobs and increased property tax revenues to local communities across Oregon.

OZ's create a reason to invest in these communities and encourage the sale of assets that may otherwise sit idle in existing securities or real estate. OZ's are an attractive alternative to paying capital gains immediately or, more likely, just sitting on the assets in order to totally avoid capital gains tax.

Instead, through an Opportunity Fund in an OZ, capital can be reinvested in equity in local businesses and real property that creates housing and employment opportunities. In return, Oregon and our local governments will receive income tax benefits through new jobs, increased property taxes, system development charges, construction excise taxes, permit fees, other "fees-in-lieu" and other revenues.

Of particular value for rural areas, OZ's allow investors to deploy capital locally, as opposed to making other investments (or keeping capital) in other assets (stocks, real estate, etc.). In urban OZ's, cities can use local ordinances (such as inclusionary zoning) to require public benefits or negotiate significant payments to be deployed for such public benefits (such as affordable housing). Even for some high-profile OZ projects, this has been the case. Any single large project generated from an OZ which generates long-term sales would raise significant property tax revenue for the local governments and generate revenue through state taxes.

Finally, OZ projects aren't as sensitive to current market cycles (overbuilding). To receive the benefits of OZ's investors must hold the asset for at least 10 years. As a result, contractors, tradespeople, architects, and other construction-dependent industries can remain more consistently employed as Oregon faces an economic downturn.

What are the risks of disconnecting?
Disconnecting will create added complexity and confusion, particularly for the Oregon investor who is willing to focus on smaller and rural community projects in Oregon. The added complexity will also make it more difficult for local and regional agencies to establish programs that leverage the incentive to achieve broadly targeted goals.

Disconnecting from the federal OZ incentive will not eliminate OZ's in Oregon. Disconnection only changes the eligibility of Oregon tax payers to realize the capital gains incentives in future years for investments made in Oregon. Out of state tax payers or multistate corporations can still invest in, and receive tax benefits from, Oregon's OZ's and Oregon investors can invest in out-of-state funds or properties in OZ's in other states.

How will disconnect affect local Oregon investors and taxpayers?
As noted by the Legislative Revenue Office "Bottom line, only Oregon taxpayers are affected by a disconnect."[1] Disconnecting from the federal code will penalize Oregon investors. HB 4010 would treat Oregon investors differently, and will not give Oregonians investing in their <u>own</u> communities the same benefits as those who invest elsewhere, or out-of-state investors spending the same money in our communities. At-best, this will lead to out-of-state ownership and control of Oregon assets at the expense of local ownership and control.

At worst, disconnecting Oregon from the federal tax code means no investment in our neediest areas. Disconnection may simply discourage Oregon taxpayers from making local investments in Oregon companies and properties. Any potential benefit of OZ's will be lost, and place Oregon as the national outlier.

Whether or not OZ's incentivize investment that may not otherwise occur is an open question, but there is no question that Oregon's disconnect can only disincentivize local investment by Oregon taxpayers.

Are there benefits to disconnecting Oregon from the OZ program?
Unclear. Unlike income taxes or property taxes, which are relatively predictable, there is no certainty that capital gains taxes foregone as part of the OZ would otherwise be realized by the state—it's just as likely if not more so that investors will keep capital in assets to avoid taxation.

Investors already have access to strategies for deferring and even eliminating capital gains. The OZ incentive won't change that. Simply put, the OZ program is not an alternative or reduction of capital gains, it is designed to encourage assets to be deployed rather than held by offering a deferral.

Secondarily, with a new, nation-wide program, Oregon will be unable to gage the returns from OZ's if we unilaterally disconnect from the program. Disconnection could also risk the value created by local governments who can negotiate with developers for additional fees designated for public benefits.

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[1] LRO Presentation to House Revenue Committee, March 11, 2019. *See OLIS, HB 2144, 2019 Legislative Session*