WISCONSIN BUDGET PROJECT

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The Top Ten Problems with Increasing Opportunity Zone Tax Breaks

Wisconsin legislators are considering a bill that would double a capital gains tax break approved two years ago, which was intended to encourage very wealthy people to invest in "distressed" areas. Although that strategy for incentivizing investments in "Opportunity Zones" was well intended, commentators across the political spectrum have noted that implementation of the recently enacted tax incentives has gone off course and will primarily benefit rich Americans, rather than the residents of low-income communities.

The Opportunity Zone tax breaks allow investors to defer taxes on capital gains by rolling those profits into funds that can invest in 120 designated census tracts. Investors who keep that money in those funds for a minimum period of time can get a reduction of the deferred capital gains, and a permanent exemption from taxation of gains on the new investments. Those tax breaks, which were enacted in Wisconsin in 2018, are on top of preexisting tax preferences for capital gains. The proposed legislation would double the new capital gains tax break for Opportunity Zones before the state has had an opportunity to assess how that tax break enacted two years ago is working.

This document explains how the "Opportunity Zone" program has strayed from the original intent because the loose criteria for eligibility to be an Opportunity Zone include many parts of the state that were already thriving, and the vast majority of the tax breaks will go to the top one percent of Wisconsinites. In addition, because the state and federal criteria for qualifying for those tax reductions do not include any requirements that the projects funded in Opportunity Zones actually benefit the people living there, some of the projects are likely to lead to gentrification that hurts low-income Wisconsinites and people of color.

1) These tax breaks are subsidizing developments that would happen anyway.

Investors in Opportunity Zones, like other investors, are typically seeking the highest financial return, so they gravitate to investments in trendy areas that are already doing very well and they typically invest in the types of projects that would occur without new subsidies. The Opportunity Zone subsidies for investors reinforce that propensity because the larger the appreciation of an investment, the larger the tax break. As a result, across the country we are seeing much of the Opportunity Zone tax breaks subsidizing high-end condominiums, apartments and retail establishments, rather than affordable housing and well-paying employment opportunities.

2) Opportunity zones primarily benefit the richest Americans

Economists and commentators across the political spectrum have pointed out that the Opportunity Zone Tax breaks are primarily benefiting the very wealthiest Americans. For example, Stan Veuger, an economist for the American Enterprise Institute, said:

> *"You can look at the criteria and tell that a lot of people will benefit from the program that don't need federal support. If you're going to try to present it as a poverty-prevention program, rich people shouldn't be the beneficiaries."*

Opportunity Funds generally have a minimum income requirement of at least $200,000 for individuals and $300,000 for couples, and that threshold excludes about 97% of Wisconsin tax filers. And when we look more closely at the distribution of capital gains income in Wisconsin among the 3% who appear to meet the income threshold, it appears that the top 1% will reap at least three-fourths of the Opportunity Zone tax breaks in our state.

3) It's premature to decide to double Wisconsin's capital gains tax break for Opportunity Zone investments.

Opportunity Zone investing is very new in Wisconsin, so it's impossible to say with complete confidence what impacts the current federal and state tax breaks will have. The state law has been in place for less than two years, and the federal regulations were completed only two months ago, which has slowed implementation of the law. Although the early evidence suggests that the program has strayed far from the original intent, one could argue that it's too soon to reach that conclusion. But by the same token, it's much too soon to decide that the state tax breaks should be increased and that policymakers should complicate the tax code by making the Wisconsin incentives different than those provided by federal law, which is something that no other state has done.

4) By using flawed federal criteria for eligibility, the Opportunity Zone program has gotten off course and is allowing thriving areas to qualify for tax credits.

A number of problems with the design and implementation of the Opportunity Zone law have resulted in the inclusion of areas that were already hubs of growth, such as the area around the UW Research Park. That zone on the west side of Madison includes Exact Sciences, a booming biotech company with a market capitalization of more than $14 billion. In some cases, census tracts with relatively high income qualify simply because they have an average income that is at least 20% less than the surrounding metropolitan area. Some economically robust areas in university towns with average family income well above the state average managed to qualify because college students are included in the count of people living in poverty, which can make a flourishing area meet the loose definition for being "distressed." In addition, a thriving commercial area whose residents are disproportionately retirees may also have low enough average income to qualify. That appears to have been a significant factor in how the census tract that includes Exact Sciences met the eligibility criteria.

5) The federal process of determining eligible Opportunity Zones used out-of-date data.

The metrics for qualifying were based on old census data, which permitted the inclusion of areas that were just starting to take off a few years ago, like the East Washington corridor in Madison. That area has enjoyed tremendous growth in recent years, but managed to qualify as a low-income area because the dated data does not reflect the boost in income from an influx of well-paid workers residing in the new high-rises on or near East Washington Avenue. And once an area is designated as an Opportunity Zone, it remains so, as long as the current legislation is in effect.

6) The state's process of designating 120 Opportunity Zones (from the list of census tracts that met the criteria) appears to have been skewed in favor of less impoverished and less racially diverse areas.

We compared the census tracts in Wisconsin that met the criteria for being an Opportunity Zone with the 120 tracts that were ultimately selected by the state in 2018. That selection process was tilted in favor of the more economically robust census tracts that were on the initial list. As a result, the census tracts that were chosen have less diverse populations than the eligible census tracts that were not included in the final list of 120 zones eligible for the Opportunity Zone tax breaks. Fox example, the share of African American residents is roughly 15% in the census tracts that were chosen, compared to about 19% in the eligible zones that were excluded. The census tracts that made the list do include many areas that are poor and/or racially diverse; however, those areas will be competing for capital investments with much more economically robust Opportunity Zones that are more attractive to wealthy individuals and corporations seeking to maximize the return on their investments.

7) Some of the Opportunity Zone investments are likely to displace people from their communities.

The selection of opportunity zones, though very flawed, is not the biggest problem. The even bigger problem is that within an Opportunity Zone, developers will generally invest in the areas that are already doing very well, and the choices they make may hurt rather than help the local residents. The choices about the types of development going into Opportunity Zones are primarily driven by the very wealthy investors who are seeking to maximize the after-tax return on the capital gains that they are reinvesting, and those choices are made with little or no input from the communities that are affected. An October 2019 column in MarketWatch, put it this way:

> "…*nothing in the law or the regulations that implement it require investment managers to care about the communities they are investing in*."

As a result, people of color and low-income residents of Opportunity Zones are likely to once again find it necessary to move from their homes because of gentrification.

8) Opportunity Zone tax breaks divert resources from schools and other services that truly promote opportunity.

Increasing the Opportunity Zone tax breaks, as the new legislation proposes, will divert additional funding from the state treasury that could be used in much more productive ways. State tax dollars that could fund schools, drug treatment, child care, job training programs, and other essential services will instead go to very wealthy investors. Right now, the fiscal estimate on the bill is relatively small, but much of the cost is deferred until future years, and several other factors are likely to boost the price tag. Those include recently approved federal regulations that substantially broadened the tax break, and the possibility that Congress will relax time limits on when the investments need to be made, which might significantly increase the fiscal impact.

9) Policymakers do a disservice to poor communities and communities of color when they inaccurately claim to have created programs that help them.

The proposed legislation (SB 440 and AB 532) is being portrayed as a cure for distressed communities, which is very misleading and potentially damaging. Creating a program that primarily helps the very rich is bad enough, but it's especially a problem when the program is incorrectly purported to be a way of helping distressed communities. That concern returns us to the statement made by Stan Veuger for the American Enterprise Institute. As he said about Opportunity Zone tax breaks, "*if you're going to try to present it as a poverty-prevention program, rich people shouldn't be the beneficiaries*."

10) Federal regulations adopted in December move the program even further from the original intent

At each step in the implementation of the Opportunity Zone program, it has shifted further and further from the original intent of helping distressed communities. That was demonstrated again in December when the IRS issued the final regulations governing the program, which became even more generous to wealthy corporate and individual investors than the previously proposed rules. For example, the final rules allow more types of capital gains income to be invested in Opportunity Zones and relaxes requirements for using the reinvested money to make improvements on property acquired in a zone. According to an analysis by the Center on Budget and Policy Priorities, the final rules will let "some businesses qualify for tax breaks without making *any* tangible investment in opportunity zones for more than *five years*."

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Appendix: Critiques of Opportunity Zones

"Why Opportunity Zones Won't Work," Howard Husock, *City Journal*, Sept. 9, 2019

"The Big Fib about Opportunity Zones and Your Tax Dollars," Adam Michel and Joel Griffith, the Heritage Foundation, July 12, 2019

"Opportunity zones are all sizzle, fizzle and the abuse of good intentions," Mark Pinsky and Keith Mestrich, MarketWatch.com, Nov. 22, 2019

"Opportunity Zones stray from original intent," Ken Wysocky, *Diggings*, the Badger Institute, Fall 2019

"States Should Decouple from Costly Federal Opportunity Zones and Reject Look-Alike Programs," Lisa Christensen Gee and Lorena Roque, Institute for Taxation and Economic Policy, Dec. 12, 2019

"4 reasons to be skeptical of tax incentives for Opportunity Zones," Stan Veuger, American Enterprise Institute blog post, Dec. 11, 2018

"Opportunity Zones Exemplify 2017 Tax Law's Fundamental Flaws," Samantha Jacoby, Center on Budget and Policy Priorities, Oct. 31, 2019

"How a Tax Break to Help the Poor Went to NBA Owner Dan Gilbert," Jeff Ernsthausen and Justin Elliott, ProPublica, Oct. 24, 2019

"Treasury Fails to Add Public Reporting Requirement to 'Roth for the Rich'," Miriam Rozen, *Financial Advisor IQ*, Dec. 26, 2019

"How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich," Jesse Drucker and Eric Lipton, New York Times, Aug. 31, 2019

"Final Opportunity Zone Rules Could Raise Tax Break's Cost," Samantha Jacoby, Center on Budget and Policy Priorities, Feb. 3, 2020

The Wisconsin Budget Project, an initiative of Kids Forward, is an independent Madison-based research group that focuses on tax and budget policy.