Opportunity Zones and Local Property Tax Assessment in California

Introduction

Opportunity Zones (OZs) are economically distressed communities where, under the Tax Cut and Jobs Act of 2017, investors may defer or eliminate federal taxes on capital gains.[1] The OZ program is a new tool designed to spur economic development and job creation in distressed communities.[2]

Although the impacts of the OZ program are uncertain, one recent estimate put the amount of unrealized capital gains nationwide at $6.1 trillion.[3] In California and elsewhere, the hope is that significant new investment in both real property and businesses will flow from the new program, which, from the standpoint of investors, is directly aimed at those unrealized capital gains. There are 879 designated OZs in California.[4]

The OZ program presents several potential areas of interest for State Board of Equalization (BOE). First, as the affordable housing crisis in California worsens,[5,6] assessors and the BOE will need to be aware of new housing developments that might qualify for relief under either the welfare exemption or because of government-imposed restrictions on use. Additionally, to further encourage development in OZs in California, the BOE may wish to consider advocating for statutory changes that would add property tax incentives to the income tax incentives that are already part of the OZ program.

The Opportunity Zone Program

The concept of OZs was introduced in a 2015 paper titled "Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas."[7] Arguing for a new type of incentive for investment in economically distressed areas, the paper cited (1) the geographically uneven recovery from the Great Recession in the United States, (2) increased costs to families forced by socioeconomic factors to remain in distressed local economies, (3) the large stock of "savings" in the form of unrealized capital gains, and (4) the failure, by and large, of several previous policy measures designed to incentivize private investment in distressed areas. The paper argued that new incentives, if properly designed, could be attractive enough to overcome the "Nash equilibrium," in which investors have chosen not to invest in a distressed locale mainly because other investors have also chosen not to invest in that locale.

In general, the OZ program works by encouraging investors with unrealized capital gains to sell their assets and reinvest the proceeds in eligible distressed areas. The encouragement comes in the form of tax incentives for the portions of those proceeds that count as capital gains for federal tax purposes.

As outlined below, the incentives for investors include (1) tax *deferral*, (2) increases in tax *basis* for investors' capital assets,[8] and (3) permanent *exclusion* from tax under certain circumstances: [9]

1) Investors can defer tax on any prior capital gains that are reinvested in a Qualified Opportunity Fund (OZ fund), which is the vehicle for investing in eligible property located in an OZ.

2) Investors are eligible for a step-up in basis for prior capital gains reinvested in an OZ fund, with the amount of the increase in basis becoming larger as the investment is held longer.

3) As to capital gains realized upon the sale of an investment in an OZ fund, the investor is permanently shielded from any tax if the investment in the OZ fund is held for at least ten years.

More specific aspects of the OZ program are being clarified as the Internal Revenue Service (IRS) develops regulations. Most recently, on April 17, 2019, the IRS published a second round of proposed regulations.[10]

Pitfalls

Gentrification

The OZ program falls into a category of tax incentives that are "place-based," wherein the goal is to attract new investment in economically distressed *geographic* areas. But evidence of the effectiveness of previous place-based incentive programs is mixed,[11] and there is a risk that the OZ program might have the unintended effect of being the catalyst for gentrification, or of accelerating gentrification already occurring.[12]

Misplaced Investments

Many areas designated as OZs are in distress, but some are not.[13] Moreover, an OZ fund can invest in businesses that have as much as 30 percent of their tangible assets located outside of designated OZs.[14] Still, by at least one measure, California's OZ designations stand out from most other states in terms targeting areas actually in economic distress.[15]

Investment Choices and Downside Risk

The OZ program is meant to attract capital to areas where investors might not otherwise put their money. But if an area was unattractive for investment purposes before being designated an OZ, it may remain unattractive, and OZ funds may bypass such areas.[16]

Additionally, while the tax breaks offered by investing in OZs may attract investment in concentrated locations, if those investments underperform, investors may choose to exit their positions, possibly at about the same time. This could exacerbate an economic downturn.[17]

Effect on Real Estate Values

A study by Zillow suggests that areas that were designated OZs saw an uptick in property values after the designation. Though property values in these areas were increasing even before the law was passed, there was an extra spike in those areas designated as OZs.[18] And there is evidence that sales of development sites in OZs have increased faster than comparable sites outside OZs. [19]

Federal Program Support

While the OZ program is meant to attract private investment into distressed communities, the White House has recognized that private investment alone will be insufficient to lift up many areas. Thus, on December 12, 2018, the president signed Executive Order 13853 to establish the White House Opportunity and Revitalization Council.[20] The council's mission is to coordinate the federal resources that can benefit OZs. According to council's implementation report in April, this coordination of private and public resources "will stimulate economic opportunity, encourage entrepreneurship, expand educational opportunities, develop and rehabilitate quality housing stock, promote workforce development, and promote safety and prevent crime in economically distressed communities. State, local, and tribal leaders have an opportunity to leverage the work of the Council and to also conduct similar reviews of their own programs and regulations."[21]

California Efforts

The Governor stated in his 2019-20 proposed budget that the state should consider conforming its income tax laws to the federal law allowing for deferred and reduced taxes on capital gains in OZs.[22] A current bill, SB 635, would conform state law to federal law for investments in OZs in California, effective in the 2019 tax year.[23,24]

In addition to calling for state conformity with federal income tax law, language in the 2019-20 Governor's proposed budget specifically states that the Governor's Office of Business and Economic Development would help foster relationships between local Enhanced Infrastructure Financing Districts (EFIDs) and OZ investors to facilitate investments in distressed areas. The budget language also pledged that "[t]he state will explore layering additional programs on Opportunity Zones and EIFDs to increase the production of affordable and moderate-income housing."[25] The state has also articulated an OZ strategy,[26] established an OZ web portal,[27] and created an OZ inter-agency working group.[28]

The Local Assessment Function

County Assessors

The elected assessors of California's 58 counties are charged with discovering, inventorying, and assessing all taxable property in the state.[29] Annually, the culmination of each county assessor's work is the local assessment roll.[30]

Related to the work of producing the annual assessment roll, assessors perform a variety of tasks. These include gathering information from taxpayers, canvassing neighborhoods and businesses, producing parcel maps, making available to the public information about sold properties, defending assessment appeals, processing claims for disaster relief for damaged property, reviewing properties for reductions in market value, and evaluating eligibility for exemptions and other property tax relief.

The Board of Equalization

The BOE has a significant oversight role with respect to county assessment practices. Specifically, the BOE must:[31]

- Prescribe rules and regulations to govern assessors and assessment appeals boards
- Prescribe and enforce the use of all property tax forms
- Prepare and issue instructions to assessors designed to promote statewide assessment uniformity

Additionally, the BOE must conduct audits, or *surveys*, of each county assessor's procedures and practices.[32] This the BOE accomplishes through its Assessment Practices Survey Program.

Opportunity Zones and Local Assessment Issues

The work of completing an assessment roll is inherently retrospective. That is, an assessor's job is to discover, inventory, and assess taxable property that is already in existence. Moreover, in assessing any new development that results from the OZ program, assessors will apply existing law and procedures; the OZ program thus will not alter the nature of an assessor's work.

Similarly, the BOE's existing statutory oversight of county assessors will be unchanged by the OZ program; all the BOE's duties and programs with respect to rulemaking, issuance of instructions and forms, and the Assessment Practices Survey program will continue, as is, under existing law.

Though investment in taxable property through the OZ program will not alter the fundamental work of either county assessors or the BOE, the OZ program could present concerns and issues of interest to both.

These property tax issues will likely include, for example: change in ownership regarding equity investments vs. security transactions or sale and lease-back transactions; impacts on property valuation related to new construction vs. repairs; clarifications of the criteria needed for housing to qualify for the Welfare Exemption; the impact of government-imposed property restrictions on property valuation; changes in base year values triggered by OZ fund investments or by changes in the use of existing property, and confusion regarding forms.

Although this is not an exhaustive list of property tax issues which could arise because of OZ fund investments, they indicate a potential need to provide additional guidance to county assessors, which can be relied upon by OZ fund investors, developers, non-profit entities, and local governments alike.

Property Tax Relief under Existing Law

As discussed more fully below, assessors and the BOE will need to be aware of any new development resulting from the OZ program that might qualify for relief under either the welfare exemption or because of government-imposed restrictions on use under Revenue and Taxation Code section 402.1.

Welfare Exemption

The Legislature has the authority to exempt property (1) used exclusively for religious, scientific, hospital, or charitable purposes, and (2) owned or held in trust by nonprofit organizations operating for those purposes. This exemption, popularly known as the welfare exemption, was first adopted by voters as a constitutional amendment on November 7, 1944.

In general, the welfare exemption from local property tax is available to property of organizations formed and operated exclusively for qualifying purposes (religious, scientific, hospital or charitable), which use their property exclusively for those purposes. Both the organizational and property use requirements must be met for the exemption to be granted.[33]

While the extent of new development that will be eligible for the welfare exemption in California's OZs is unknown, assessors and the BOE will be involved in approving the exemption when such development does occur.

Government-Imposed Restrictions on Use

Revenue and Taxation Code section 402.1 generally requires assessors, in the valuation of land, to recognize the effect of government-imposed restrictions on use. Privately imposed use restrictions are disregarded by assessors unless the law specifies otherwise.

If any new development in an OZ comes with government-imposed restrictions on use as contemplated by Revenue and Taxation Code section 402.1, assessors and the BOE will need to evaluate whether those restrictions must be recognized for assessment purposes under existing law.

Proposing New Forms of Property Tax Relief

The BOE could advocate for statutory changes that would add property tax incentives to the income tax incentives that are already part of the OZ program. Additional relief could take several forms:

- Expansion of the kinds of restrictions on use that assessors must recognize under Revenue and Taxation Code section 402.1
- Expansion of the welfare exemption so that characteristics of OZ property would be recognized
- Addition to the state Constitution of new property tax relief for new construction in OZs

Enforceable Restrictions on Use

In recent years the Legislature has added several types of private use restrictions to the list contained in section 402.1. These include contracts applied to homes constructed and sold by Habitat for Humanity,[34] as well as Community Land Trusts.[35]

The BOE may wish to consider advocating for legislation that would make section 402.1 applicable to new development in OZs, provided the characteristics of any such new development fit the general intent of section 402.1.

Welfare Exemption-Affordable Housing

Specifically related to affordable housing, the implementing statutes make the welfare exemption available to property used exclusively for rental housing and related facilities under certain conditions. Additionally, such property may receive a partial exemption based on the proportion of units serving lower income households under certain conditions, including that the owner receives Low Income Housing Tax Credits (LIHTCs) under section 42 of the Internal Revenue Code.

The BOE may wish to consider advocating for legislation that would make the welfare exemption available to low-income housing in OZs, depending on the characteristics of specific projects.

New Construction Exclusion

In general, under article XIIIA of the California Constitution, newly constructed property is assessed at its market value as of the date construction was completed. For property tax purposes, "new construction" includes not only new structures and additions, but also remodeling and rehabilitation—depending on whether the work converts an existing structure (or a portion of a structure) to the equivalent of new. New construction also includes alterations of land or improvements that convert the land or improvements to a different use.[36]

Since article XIIIA was adopted by California voters in 1978, there have been several constitutional amendments that authorize the Legislature to provide for exclusions from the general rule that new construction, as described above, is assessable on the date of completion. The types of construction excluded by these amendments include solar energy improvements, fire suppression improvements, seismic safety improvements, work done to make property more accessible to disabled people, and others.[37]

With respect to new construction in OZs, the BOE may wish to advocate for a constitutional amendment to exclude certain projects (e.g., new structures, remodeling and rehabilitation of existing structures) from the general rule that new construction is assessable at its market value on the date construction is completed.

In conclusion, there may be a need for more fact-finding among stakeholders to determine the extent what guidance may be provided by the BOE.

Endnotes

[1] A capital gain is an increase in the value of a capital asset (securities or real estate) since the date of acquisition. The gain is not realized until the asset is sold. A capital gain is considered income for federal income tax purposes. *Investopedia*, https://www.investopedia.com/terms/c/capitalgain.asp

[2] *Opportunity Zones Frequently Asked Questions | Internal Revenue Service* https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

[3] "Opportunity Zones: Tapping into a $6 Trillion Market." *Economic Innovation Group*, 21 Mar. 2018, https://eig.org/news/opportunity-zones-tapping-6-trillion-market

[4] *Opportunity Zones. http://business.ca.gov/Programs/Opportunity-Zones*

[5] *Addressing a Variety of Housing Challenges*. http://www.hcd.ca.gov/policy-research/housing-challenges.shtml

[6] *California's High Housing Costs: Causes and Consequence*. https://lao.ca.gov/Publications/Detail/3214

[7] "Opportunity Zones History." *Economic Innovation Group*, https://eig.org/opportunityzones/history

[8] An investor's tax basis is generally the amount invested in an asset. The IRS uses basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange, or other disposition of the property. *Topic No. 703 Basis of Assets | Internal Revenue Service*. https://www.irs.gov/taxtopics/tc703

[9] *Opportunity Zones Frequently Asked Questions | Internal Revenue Service*.

[10] *IRS Issues Guidance Relating to Deferral of Gains for Investments in a Qualified Opportunity Fund | Internal Revenue Service.* https://www.irs.gov/newsroom/irs-issues-guidance-relating-to-deferral-of-gains-for-investments-in-a-qualified-opportunity-fund

[11] *Do Place-Based Policies Matter?* Federal Reserve Bank of San Francisco, https://www.frbsf.org/economic-research/publications/economic-letter/2015/march/enterprise-zone-economic-incentive-tax-subsidy-place-based-policies

[12] "Opportunity Zones: Gentrification on Steroids?" *The Kinder Institute for Urban Research*, https://kinder.rice.edu/urbanedge/2019/02/20/opportunity-zones-gentrification-steroids

[13] Looney, Hilary Gelfond and Adam. "Learning from Opportunity Zones: How to Improve Place-Based Policies." *Brookings*, 19 Oct. 2018, https://www.brookings.edu/research/learning-from-opportunity-zones-how-to-improve-place-based-policies

[14] Rosenthal, Steve. "IRS Proposes Generous Rules For Opportunity Zone Investors, But What Will They Mean For Communities?" *Forbes*, https://www.forbes.com/sites/stevenrosenthal/2018/10/23/irs-proposes-generous-rules-for-opportunity-zone-investors-but-what-will-they-mean-for-communities

[15] Looney, Adam. "The Early Results of States' Opportunity Zones Are Promising, but There's Still Room for Improvement." *Brookings*, 18 Apr. 2018, https://www.brookings.edu/research/the-early-results-of-states-opportunity-zones-are-promising-but-theres-still-room-for-improvement/

[16] "The Federal Opportunity Zones Program and Its Implications for California Communities." *California Budget & Policy Center*, 23 Apr. 2019, https://calbudgetcenter.org/resources/the-federal-opportunity-zones-program-and-its-implications-for-california-communities/

[17] Fitzgerald, Maggie. "These Funds Make It Easier to Cash in on Trump's 'opportunity Zone' Tax Break That Favors the Rich." *CNBC*, 30 Mar. 2019, https://www.cnbc.com/2019/03/30/retail-investors-can-get-a-piece-of-opportunity-zone-tax-breaks.html

[18] "Sale Prices Surge in Neighborhoods with New Tax Break." *Zillow Research*, 18 Mar. 2019, https://www.zillow.com/research/prices-surge-opportunity-zones-23393

[19] Grant, Peter. “Developers Look to Hit Tax-Break ‘Jackpot’ in Opportunity Zones.” *WSJ*, https://www.wsj.com/articles/developers-look-to-hit-tax-break-jackpot-in-opportunity-zones-1540296000

[20] “Executive Order on Establishing the White House Opportunity and Revitalization Council.” *The White House*, https://www.whitehouse.gov/presidential-actions/executive-order-establishing-white-house-opportunity-revitalization-council/

[21] https://www.hud.gov/sites/dfiles/PA/documents/OppZone_Agency_Completed_Actions.pdf

[22] *FAQs – CA OZs*. https://opzones.ca.gov/faqs/.

[23] *Bill Text - SB-635 Taxation: Gross Income Exclusions: Opportunity Zones. http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201920200SB635*

[24] As of July 3, 2019, the bill was being held under submission.

[25] *Opportunity Zones*.

[26] *California’s Opportunity Zone Strategy – CA Opportunity Zones*. https://opzones.ca.gov/strategy/

[27] *CA Opportunity Zones – Opportunity Zones Provide Tax Incentives for Investment in Designated Census Tracts.* https://opzones.ca.gov/

[28] *State Agency Contacts – CA Opportunity Zones*. https://opzones.ca.gov/state-agency-contacts/

[29] Under section 19, article XIII of the California Constitution, the BOE is charged with discovering and assessing property owned or used by regulated railway, telegraph, or telephone companies; car companies operating on railways in the state; companies transmitting or selling gas or electricity; and pipelines, flumes, canals, ditches, and aqueducts lying within two or more counties. All these property types are considered “state assessed property.”

[30] Revenue and Taxation Code section 601.

[31] Government Code section 15606.

[32] Government Code section 15640.

[33] *Property Tax Payment & Relief - Welfare or Veterans’ Organization Exemptions - Frequently Asked Questions*. http://www.boe.ca.gov/proptaxes/faqs/welfarevetsfaqs.htm#1

[34] *Bill Text - AB-668 Property Taxation: Assessment: Affordable Housing.* http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB668

[35] *Bill Text - AB-2818 Property Taxation: Community Land Trust.* http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201520160AB2818

[36] Revenue and Taxation Code section 70.

[37] Article XIIIA, section 2, subdivision (b).