THE LIMITS OF "OPPORTUNITY": A THREE-PRONGED ANALYSIS OF THE IMPLICATIONS OF QUALIFIED OPPORTUNITY FUNDS

*By Julia Salzman**

* Julia is pursuing her Juris Doctor at the University of Houston Law Center, with an expected graduation date in May 2024. She serves as the Chief Articles Editor on Board 24 of the Houston Business and Tax Law Journal and previously held the position of Treasurer for the Corporate and Taxation Law Society during the 2022–2023 school year.

I. Introduction

Qualified Opportunity Funds ("QOF" or "QOFs") have failed to provide the economic revitalization intended by Congress. However, some proposed changes to QOFs may increase their economic benefits. Congress should amend current law to narrow the scope of Opportunity Zone investments to specific kinds of real estate and enforce stricter reporting requirements for QOFs.

A QOF is an "investment vehicle . . . that holds at least 90 percent of its assets in qualified opportunity zone property."[1] Opportunity Zones are low-income tracts certified by the Secretary of the U.S. Treasury.[2] To receive the tax benefits, investors must invest in a QOF before December 31, 2028.[3] Investors in a QOF may defer and reduce liability on capital gains that are invested into a QOF within 180 days after the gains are realized.[4] Early adopters of the QOF provisions, those who invested before December 31, 2019, may be eligible for complete elimination of total tax liability on capital gains by receiving a stepped-up basis equal to the property's fair market value on the date of disposition.[5]

This article conducts an analysis on the social and economic effectiveness of QOFs. The analysis consists of three parts: a balancing test between the competing interests of Opportunity Zone investors and residents, a "tax justice" analysis of the goals of the Tax Code,[6] and an analysis of alternative tax benefit expansions for low-income taxpayers.

II. Balancing Test: QOF Investors and Opportunity Zone Residents

The first step in the analysis is to compare the interests of the QOF investors to those of the Opportunity Zone residents.

A. Interests of the QOF Investors

QOFs can offer extensive tax benefits to investors. All capital gains are eligible to be invested in a QOF, including short-term capital gains.[7] Further, eligible capital gains are not limited to capital gains from real property.[8] Accordingly, QOF benefits impact a wide variety of investors.[9]

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1. I.R.C. § 1400Z-2(d)(1).
2. I.R.C. § 1400Z-1(b)(1).
3. Matthew R. Joyce, Esq., *In the (O)zone: New Tax Program Guides Investor Capital to Areas of Need*, 68-AUG R.I. BAR J. 9 (2019).
4. I.R.C. § 1400Z-2(a)(1)(A); Joyce, *supra* note 3, at 9–10.
5. I.R.C. § 1400Z-2(c).
6. *See generally* W. Edward Afield, *Social Justice and the Low-Income Taxpayer*, 64 VILL. L. REV. 347 (2019) (arguing that social justice gains occur when tax justice is prioritized).
7. Treas. Reg. § 1.1400Z2(a)-1 (2020); Steve Hadjilogiou and Keith Hagan, *How to Invest in a QOF*, MCDERMOTT WILL & EMORY (Oct. 21, 2021), https://www.mwe.com/insights/how-to-invest-in-a-qof/.
8. I.R.C. § 1400Z-2(a); Hadjilogiou, *supra* note 7.
9. *See* Hadjilogiou, *supra* note 7.

By August 2022, Novogradac, a professional services organization, estimated the total investment in QOFs to be over $30 billion, taken from voluntarily self-reported data from QOF investors.[10] Because this data is voluntarily self-reported, Novogradac estimated that the actual dollar amount of investment in QOFs to be three to four times greater.[11] Accordingly, the total net tax savings and deferrals that QOF investors will enjoy by 2026 are staggering.[12]

A relevant consideration to the analysis is other available alternative investment vehicles for capital gain deferral. A popular method of tax deferral among real estate investors is section 1031 like-kind exchanges.[13] This provision allows a real estate investor to swap real estate property used in a trade or business with another investor's property, creating a deferral of gains or losses recognized on the original property.[14] Section 1031 exchanges may be a viable alternate solution for investors looking to defer capital gains from real estate properties. However, for investors faced with recognition of non-real estate-related capital gains, section 1031 exchanges are not a viable alternative.

B. Interests of the Opportunity Zone Residents

According to the White House Opportunity and Revitalization Council, "a lack of access to economic opportunity can lead to negative outcomes in the vital measures that matter to all communities."[15] For example, the median household income of the opportunity zones is $49,000, 35% below the national median.[16] The poverty rate of the Opportunity Zones is 26.4%, compared to the national rate of 13.4%.[17] Educational attainment in Opportunity Zones is strained compared to the nation as a whole.[18] Another challenge faced by opportunity zones is the significantly higher rate of incarceration.[19]

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10. Michael Novogradac, *Latest Novogradac QOF Report Shows OZ Investment Surpasses $30 Billion*, NOVOGRADAC (Aug. 9, 2022), https://www.novoco.com/notes-from-novogradac/latest-novogradac-qof-report-shows-oz-investment-surpasses-30-billion#:~:text=Investments%20in%20QOFs%20tracked%20by,dollar%20amount%20of%20equity%20raised.

11. *Id.*

12. *See id*.

13. *See* I.R.C. § 1031.

14. *Id.*

15. Report to the President from the White House Opportunity and Revitalization Council (Dec. 2019) https://opportunityzones.hud.gov/sites/opportunityzones.hud.gov/files/documents/OZ_One_Year_Report.pdf.

16. *Opportunity Zone Statistics*, IPROPERTY MGMT., https://ipropertymanagement.com/research/opportunity-zone-statistics (last updated Jun. 4, 2022).

17. *Facts & Figures*, ECON. INNOVATION GROUP (Dec. 2020), https://eig.org/opportunity-zones/facts-figures/.

18. *Id.*

19. *Opportunity Atlas Data Tables*, U.S. CENSUS BUREAU, https://www.census.gov/programs-surveys/ces/data/public-use-data/opportunity-atlas-data-tables.html (last updated Oct. 11, 2022).

Congress intended investment in Opportunity Zones to create jobs, improve residential and commercial real estate, and spur economic revitalization.[20] It is undisputed that the need to improve high-poverty communities is dire; however, it has not been established that the current capital investment in QOFs has resulted in the intended benefits.[21]

As a result of few restrictions and limited guidance regarding QOFs, there are many ways in which a QOF can take advantage of the substantial Opportunity Zone tax benefits while doing little to improve the economy or quality of life for the residents of the Zones.[22] With virtually no government oversight, clever investors can devise ways to create tax windfalls while avoiding the addition of any significant economic value to the Zones.[23]

Further, a study conducted by the Urban Institute shows that the tracts of land chosen were often not low-income and were not the most in need of new capital.[24] Additionally, the Center on Budget and Policy Priorities reported that the definition of "low-income community" is broad enough to encompass land occupied by mostly university students, such as land surrounding elite universities like the University of Virginia and the University of California at Berkeley.[25]

Another major risk of QOF investment is the potential for displacement.[26] Gentrification usually involves the influx of wealthy, educated individuals into communities that were previously home to poor or working-class individuals.[27] There is an abundance of scientific and empirical data demonstrating the economic impact of gentrification; however, these quantitative methods fail to capture one of the most significant impacts of gentrification: the dilution of the culture of the gentrified communities.[28]

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20. *See* Press Release, *Senator Tim Scott (R-SC), Senator Cory Booker (D-NJ), Congressman Pat Tiberi (R-OH), and Ron Kind (D-WI), Investing the Opportunity Act, (Feb. 2, 2017) https://www.scott.senate.gov/media-center/press-releases/senator-scott-introduces-the-bipartisan-investing-in-opportunity-act.*

21. Adam Looney, *Will Opportunity Zones Help Distressed Residents or be a Tax Cut for Gentrification?*, BROOKINGS (Feb. 26, 2018), https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/.

22. *Id.*

23. *Id.*

24. Tatiana Kimbo & Richard Phillips, *How Opportunity Zones Benefit Investors and Promote Displacement*, INST. ON TAX'N AND ECON. POL'Y (Aug. 10, 2018), https://itep.org/how-opportunity-zones-benefit-investors-and-promote-displacement/.

25. Samantha Jacoby, *Potential Flaws of Opportunity Zones Loom, as Do Risks of Large-Scale Tax Avoidance*, CTR. ON BUDGET AND POL'Y PRIORITIES (Jan. 11, 2019), https://www.cbpp.org/research/federal-tax/potential-flaws-of-opportunity-zones-loom-as-do-risks-of-large-scale-tax.

26. Looney, *supra* note 21.

27. Jason Richardson, et al., *Shifting Neighborhoods*, NAT'L COMTY. REINVESTMENT COAL. (Mar. 19, 2019), https://ncrc.org/gentrification/.

28. *Id.*

On the other hand, proponents of gentrification argue that gentrification promotes integration of communities and lowers poverty rates.[29] As new capital investments increase property value and the curb appeal of low-income neighborhoods, there is less exposure to poverty for all the residents of the gentrified communities.[30]

Even residents of low-income communities have split opinions about the benefits of gentrification. An article by the National Community Reinvestment Coalition quotes one Maryland resident asking, "When can we get some of that (gentrification) in my community?"[31] Despite the mixed opinions, the resounding desire across all low-income community residents is for protection from displacement and continued access to affordable housing.[32]

III. TAX JUSTICE ANALYSIS

In his testimony before the Joint Economic Committee, Jared Bernstein[33] stated that "[t]he goal of the system should be to raise the revenue necessary to fund the government services and public goods Americans want and need, and to do so in a way that's fair, equitable, pro-growth, and avoids unnecessary complexity."[34] Two main touchstones in analyzing whether a provision is fair, equitable, and pro-growth are horizontal equity and vertical equity.[35]

The basis for the theory of horizontal equity is that taxpayers in similar circumstances should pay equal taxes.[36] One foundational principle of horizontal equity is distributive justice.[37] This principle argues that all taxpayers should pay the same amount of taxes in proportion to their earned income.[38] Under this principle, every taxpayer should be in the same economic position before and after

29. Joe Cortright, *How Gentrification Benefits Long-Time Residents of Low Income Neighborhoods*, CITY COMMENTARY (July 19, 2019), https://cityobservatory.org/how-gentrification-benefits-long-time-residents-of-low-income-neighborhoods/.

30. *Id.*

31. Richardson, *supra* note 27.

32. Jerusalem Demsas, *What We Talk About When We Talk About Gentrification*, VOX (Sept. 5, 2021 8:00 AM EDT), https://www.vox.com/22629826/gentrification-definition-housing-racism-segregation-cities.

33. Jared Bernstein is a senior fellow at the Center for Budget and Policy Priorities and former chief economist and economic advisor to Vice President Biden during the Obama Administration. *Jared Bernstein*, THE HAMILTON PROJECT, https://www.hamiltonproject.org/people/jared-bernstein/ (last visited Oct. 21, 2023).

34. Jared Bernstein, *Meeting the Goals of the Federal Tax System*, CTR. ON BUDGET AND POL'Y PRIORITIES (Apr. 20, 2016), https://www.cbpp.org/research/federal-tax/meeting-the-goals-of-the-federal-tax-system.

35. *Horizontal Equity*, CFI EDUC. INC. (last visited Oct. 21, 2023), https://corporatefinanceinstitute.com/resources/knowledge/finance/horizontal-equity/.

36. *Id.*

37. *Id.*

38. *Id.*

taxes.[39] Thus, a system that allows for preferential types of income is not horizontally equitable.[40]

In contrast to horizontal equity, the theory of vertical equity promotes a progressive tax system, where tax rates increase as a taxpayer's income increases.[41] In other words, taxpayers with higher levels of disposable income should pay at increasingly higher tax rates.[42] Vertically equitable systems can be horizontally equitable when all taxpayers are treated equally in each respective income tax bracket.[43]

A study conducted by the Center on Budget and Policy Priorities shows that preferential treatment of capital gains is highly regressive, benefiting only the top 20% of taxpayers.[44] Taxpayers in the bottom 80% of income earners did not realize any after-tax benefit from the preferential treatment of investment gains, while those in the top 20% of income earners received an increase in after-tax income ranging from 2–7.6%.[45]

The tax benefits derived from the investments in QOFs violates both vertical and horizontal equity. The tax benefits of QOFs only benefit those that have the disposable income to invest.[46] George Stocker, a professor at George Washington University, refers to QOFs as a "windfall benefit" to investors.[47]

While higher bracket taxpayers are enjoying the tax benefits of QOFs, the lower tax bracket Opportunity Zone residents are not experiencing the same increase in wealth.[48] Opportunity Zone residents may not benefit from the presumed public development benefits of QOFs nor are they able to reap the tax benefits of QOFs.[49] Even worse, Opportunity Zone residents may be negatively impacted by the effects of gentrification, further shifting the policy away from vertical equity.[50]

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39. *Id.*
40. Bernstein, *supra* note 34.
41. *Id*.
42. *Id.*
43. *Horizontal Equity*, *supra* note 35.
44. Bernstein, *supra* note 34.
45. *Id*.
46. *See id*.
47. Jeff Ernsthausen & Justin Elliott, *An Opportunity for the Rich*, N.Y. PUB. RADIO (June 19, 2019), https://www.wnycstudios.org/podcasts/trumpinc/episodes/trump-inc-opportunity-for-rich.
48. *See* Michelle D. Layser, *An Opportunity for Reform: Taxation, Inequality, and Opportunity Zones*, 2021 U. ILL. L. REV. ONLINE 20 (2021).
49. *Id*.
50. *See* Richardson, *supra* note 27.

IV. EXPANSION OF OTHER TAX BENEFITS FOR LOW-INCOME TAXPAYERS

The Earned Income Tax Credit ("EITC") "is a refundable tax credit for low- and moderate-income workers."[51] A 1989 article in the Wall Street Journal characterizes the EITC as "emerging as the antipoverty tool of choice among poverty experts and politicians."[52] Despite the success of the credit[53], data published by the Congressional Research Service suggests that the average dollar amount received per recipient has been slowly declining since tax year 2015.[54] This can be credited in part to lawmakers enacting several laws that have increased the difficulty for certain taxpayers to claim the credit.[55]

Additionally, under the TCJA, the measure of inflation for the credit was permanently changed from the consumer price index for urban consumers ("CPI-U") to the chained consumer price index ("C-CPI-U") for urban consumers.[56] The C-CPI-U "tends to grow more slowly" than the CPI-U.[57] Thus, the taxpayer will receive less money with the use of the C-CPI-U part of the EITC formula.[58] Further, participation in the EITC among those who are eligible remains low.[59] In 2016, only 78% of those who were eligible for the credit received the credit.[60] Maximizing participation in the EITC may be a worthwhile way to afford low- and moderate-earning taxpayers with a direct tax benefit.

V. PROPOSAL

Congress should impose a reporting requirement that requires QOFs to demonstrate that the investments actually benefit the residents and businesses of the Opportunity Zones. Additionally, the focus of investment should be on building and improving real estate based on the needs of the community. Such real estate may include affordable housing, public buildings, and retail space.

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51. Sabrina Parys and Tina Orem, *Earned Income Tax Credit (EITC): What It Is, How to Qualify*, NERDWALLET (Jan. 4, 2023), https://www.nerdwallet.com/article/taxes/can-you-take-earned-income-tax-credit; *see* I.R.C. § 32(a).

52. Margot L. Crandall-Hollick, *The Earned Income Tax Credit (EITC): Legislative History*, CONG. RSCH. SERV., https://sgp.fas.org/crs/misc/R44825.pdf (last updated Apr. 28, 2022) (quoting David Wessel, Expanded Earned-Income Tax Credit Emerges As the Anti-Poverty Program of Choice for Many, WALL ST. J. (July 13, 1989)).

53. *See* Aidan Davis, *Boosting Incomes and Improving Tax Equity with State Earned Income Tax Credits in 2022*, INST. ON TAX'N AND ECON. POL'Y (Sept. 15, 2022), https://itep.org/boosting-incomes-and-improving-tax-equity-with-state-earned-income-tax-credits-2022/.

54. Crandall-Hollick, *supra* note 52.

55. *Id.*

56. *Id.*

57. *Id.*

58. *Id.*

59. Margot L. Crandall-Hollick et al., *The Earned Income Tax Credit (EITC): How It Works and Who Receives It*, CONG. RSCH. SERV., https://sgp.fas.org/crs/misc/R43805.pdf (last updated Jan. 12, 2021.)

60. *Id.*

Further, Congress should take action to ensure that only the neediest communities are targeted by the QOF provisions. Areas such as Oakland, Los Angeles, and New York[61] that were rapidly gentrifying before the enactment of the QOF provisions should be excluded from Opportunity Zone designation. This would prevent granting windfalls to investors who were active in rapidly gentrifying areas prior to the QOF provisions and ensure overlooked communities receive capital investment.

Additionally, Congress should focus on aspects such as job creation and employment when drafting the extension of the QOF provisions. Such requirements could involve mandatory job creation or the requirement that QOFs hire local contractors for construction and renovation jobs.

Aside from the reform to the QOF provisions, lawmakers should focus on expanding and protecting the EITC. Since its inception in 1975, the credit has undergone many revisions and expansions,[62] and Congress' willingness to accept expansion of the credit in the past suggests that expansion is now feasible. Unlike the QOF provisions, the EITC has a direct monetary benefit to low- and moderate-earning taxpayers.

VI. CONCLUSION

Qualified Opportunity Funds can provide significant reductions and deferrals of tax on capital gains for investors. With limited alternative investment vehicles for the deferral of capital gains, the significant amount of capital gains invested in QOFs is unsurprising. However, residents of Opportunity Zones face the impacts of regulated gentrification. Stricter requirements to ensure the funds meet the needs of the communities should be a priority at the time of extension or renewal of the QOF provisions.

61. Jacoby, *supra* note 25.
62. *See* Crandall-Hollick, *supra* note 52.