TESTIMONY BEFORE THE JOINT ECONOMIC COMMITTEE OF THE UNITED STATES CONGRESS

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Introduction:

Chairman Paulsen, Ranking Member Heinrich, and members of the Committee:

I am pleased to be able to join you this morning to discuss Opportunity Zones. LISC championed the Investing in Opportunity Act (IIOA) legislation that became the foundation for the Opportunity Zones initiative, and were pleased to see this enacted in December of 2017 as part of the Tax Cuts and Jobs Act (TCJA).

Based largely on LISC's experience working in low income communities, and our deployment of private sector capital through tax credit investments like the Low Income Housing Tax Credit and New Markets Tax Credit, we believe the Opportunity Zones initiative has tremendous potential to attract new investment capital into low income urban and rural communities. Though still early in the implementation phase, there is already great energy in the community development sector in support of this program. We are pleased that all states and territories have elected to identify Opportunity Zones, and that they generally appear to have targeted geographic areas that are in need of incentives for investment.

That being said, we know there is much uncertainty ahead. Congress may need to adopt some technical corrections to ensure better program outcomes. The Treasury Department and the Internal Revenue Service (IRS) must enact regulations and guidance that not only provides investors with the clarity and certainty necessary to make investments in Opportunity Funds, but also protects against program abuse and helps ensure the integrity of the program. Finally, it will be necessary for states, localities and community development practitioners to work together to identify a largely untapped network of investors and to help steer this capital to communities of opportunity, so that the Opportunity Zones initiative lives up to its great promise.

Background on LISC

The Local Initiatives Support Corporation (LISC) is a national non-profit Community Development Financial Institution (CDFI) that is dedicated to helping community residents transform distressed neighborhoods into healthy and sustainable communities of choice and opportunity — good places to work, do business and raise children. LISC mobilizes corporate, government and philanthropic support to provide local community development organizations with loans, grants and equity investments; technical and management assistance; and policy support.

LISC has local programs in 31 cities, and partners with 86 different organizations serving over 2,000 rural counties in 44 states throughout the country. Over the course of LISC's nearly 40 years of work, its comprehensive approach to community development and its broad national reach have made it a unique and valuable leader in the fight to improve quality of life in communities across the country. LISC's greatest success over these years has been working with under-resourced communities and their residents to help them get ahead. Today, the growing inequality, concentrated poverty and racial inequity that our country is experiencing make the work that we and our partners do as urgent as ever before.

An opportunity gap – reflected in disparities in health and wellbeing, employment, wealth and financial security, and overall quality of life – is increasingly dividing America, both urban and rural communities alike. This opportunity gap does not stem from any single root: it arises from imbalanced access to basic needs like safety, housing and healthcare, as well as inequality of educational and economic opportunities. To address such complex problems requires a set of equally multi-dimensional tools and strategies.

LISC believes that catalyzing opportunity involves working at the local level to foster resilient, safe and healthy communities and towns in which individuals have financial security, economic choices and a high quality of life. With our deep local roots, national breadth, and comprehensive set of products and services, we fight to close the opportunity gap in America through our strong network of over 2,300 community-based partners.

LISC's use of Community Investment Tax Credits

As one of the largest national nonprofit housing and community development organizations in the country, LISC often relies upon public-private partnerships to engage in the type of comprehensive community development work that is needed in low-income communities. Two of the most critical federal tools that support our efforts are the Low Income Housing Tax Credit (the Housing Credit) and the New Markets Tax Credit (NMTC).

Since these programs were established in 1986 and 2000, respectively, they have become an integral component of efforts to support affordable housing development and, as importantly, the revitalization of the surrounding neighborhoods. Driven by the private sector, the federal investments made into these programs by way of tax expenditures have paid strong dividends by sparking investment in areas that would otherwise be overlooked.

The Housing Credit has financed the development of approximately 3 million affordable homes across the nation with projects in every state, leveraged more than $100 billion in private capital, and helped to create well over 3 million jobs in the construction and property management industries.[1] It is the country's most successful affordable housing production program.

LISC, through its subsidiary the National Equity Fund (NEF), is one of the nation's largest syndicators of Housing Credits. To date, NEF has invested $14.4 billion in more than 2,500 housing properties, creating approximately 166,600 affordable homes for low-income families in 47 states, and spurring the creation of an estimated 203,300 jobs. In recent years, LISC has been able to use the credit to support disaster recovery efforts, a veterans housing initiative, and an initiative to link housing to critical community health services.

NMTCs are the perfect tool to complement the work we've been doing in support of affordable housing. LISC believes that housing is just one component of vibrant communities; that residents also need to have access to good jobs, a thriving retail environment, and critical community services such as childcare, education, and health care. With NMTCs, LISC has revitalized commercial corridors and fueled commercial and retail jobs; funded new and expanded community facilities supporting jobs in the fields of education, healthcare and childcare; and redeveloped industrial brownfields to return land to productive use for offices, warehouses and new manufacturing ventures.

LISC has placed $963 million of NMTC investments in 118 different businesses and real estate projects, supporting $2.5 billion in total project costs. These funds have helped to develop or rehabilitate over 600 units of housing and 9.5 million square feet of commercial and community space, and have supported the creation or retention of 20,000 jobs.

It is precisely because we've seen first-hand the impacts that tax incentives can have on spurring community revitalization that we are convinced of the potential held by the Opportunity Zones initiative – not as a replacement for these programs, but as a valuable new tool that can attract new investor capital.

The Promise and Potential Perils of Opportunity Zones

The Opportunity Zones initiative is unlike the Housing Credit and NMTC program in several ways. First, the main source of investment capital is likely to be high net worth individual investors, as opposed to the financial institutions that are the primary investors in the other community development credits. This means that an entirely new pool of investor capital can be attracted to community development finance through Opportunity Zones. Second, there is no "cap" on the amount of investor capital that can be invested in Opportunity Funds, meaning that the program has the potential to shift massive amounts of new investor capital into low-income communities. And third, there are no designated agencies (e.g., the state Housing Finance Agencies, the Treasury Department's CDFI Fund) pre-approving projects or business plans,

[1] "Low Income Housing Tax Credit Impacts in the United States", Affordable Rental Housing ACTION: http://www.rentalhousingaction.org/files/National%20Fact%20Sheet.pdf

which should significantly lower transaction costs and expedite investments into these communities.

Yet there are potential negative outcomes that may occur as well. For example, the way the incentive is structured, investors will get a modest return through deferral of initial capital gains taxes, but a potentially huge return with the forgiveness of any additional capital gains that result upon exit from the Opportunity Fund investment. This means investors may be incentivized to seek out the deals with the highest long term yields, which may not be the projects that bring about the most impact for the community or its residents. And without any Federal or state agencies overseeing the selection of projects and investment plans, there is no direction to necessarily pursue higher impact community development investments. Additionally, one could potentially see this program leading to displacement of lower income community residents, either because the neighborhoods themselves get "overheated" with investment capital, or because the structure of the incentive rewards investors seeking the higher yields offered by market rate or even luxury housing.

It is LISC's intent to design an Opportunity Zone investment plan that will attract capital from impact investors throughout the country while maximizing the benefits for low-income communities and their residents. We are planning to focus our Opportunity Zone investments in three areas where we see the greatest potential to benefit community residents:

1. Operating businesses – providing growth capital for companies that are creating job opportunities for Opportunity Zone residents. We will inject equity capital to catalyze the growth of manufacturing, health care, and other companies in growing sectors that are providing quality job opportunities that are accessible to community residents.

2. Business infrastructure – investing in new real estate developments and rehabilitation of existing underutilized buildings within targeted communities to attract businesses, bringing quality jobs to underinvested communities and their adjacent neighborhoods.

3. Affordable housing – increasing the stock of quality affordable and workforce housing in Opportunity Zones

We will raise capital from mission-aligned investors including the corporations located in Opportunity Zones that we are already targeting for investment, high net worth individuals sourced through our community foundation relationships, and the growing impact investment community. With strong continued leadership from Congress and the implementation of our recommendations herein, we believe that the Opportunity Zones incentive can spur billions in private investment activity in the country's most distressed census tracts and play a major role in closing the existing opportunity gap that is leaving these communities behind.

Opportunity Zone Implementation to Date

LISC has been very pleased with the initial response to the Opportunity Zones initiative from state and local practitioners, as well as the community development industry. There has been a tremendous amount of interest from various parties in learning about this new program. It is our understanding that all 50 states and the US territories have submitted their Zone designations to the Treasury Department, and while we are still awaiting Treasury's approval for about half of these submissions, the ones that have been approved and publicly identified suggest that the states and territories are treating this initiative thoughtfully, and are by and large doing a good job of identifying their Zones.

Specifically, as reported by the Treasury Department's CDFI Fund, the Zones that had been approved as of April 18, 2018 (encompassing 4,831 census tracts in 24 states and territories) had an average poverty rate of 35%, significantly higher than the minimum rate of 20% required by the statute. These tracts also had an unemployment rate that was, on average, 78% higher than the national average. States also did a good job dispersing their Opportunity Zones, with 22% of the census tracts located in rural communities.

With respect to the Treasury Department's implementation of Opportunity Zones, however, we do have some early concerns. Specifically, in regards to the Opportunity Zone approvals, while we appreciate Treasury's desire not to slow down the process with a lengthy review, we believe that there was an opportunity missed by Treasury to engage in more than just the straightforward mechanical exercise in which they've chosen to engage. Specifically, the Conference Report that accompanied Tax Cut and Jobs Act (Report 115-466) <u>required</u> that Governors provide particular consideration to areas that:

a) are currently the focus of mutually reinforcing state, local or private economic development initiatives to attract investment and startup activity;

b) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones and renewal communities; and

c) have recently experienced significant layoffs due to business closures or relocations.

To this end, we recommended to Treasury that each state be required to submit a brief narrative explanation demonstrating the extent to which the Opportunity Zones they have designated satisfy one or more of these three considerations. We felt that that this would have at least served as a reminder to States of the factors that Congress had intended them to consider, and remain disappointed that Treasury didn't choose to pursue this approach.

We also are concerned with early indications that the Treasury Department intends to take a minimalist approach to its next phase of administrative oversight, which is the certification of Opportunity Funds. Specifically, the IRS recently released an Opportunity Zones Frequently Asked Questions document stating that Opportunity Funds will self-certify --- that "no approval or action by the IRS is required."

The concept of certification of Opportunity Funds by the Treasury Department was a rare instance of an element of the Opportunity Zones legislation that was not drawn from the initial IIOA proposal – but rather was added into the Opportunity Zone provision during the enactment of the TCJA. We believe it was the intent of Congress to at a minimum create a safeguard against potentially bad actors abusing the program, but also to potentially offer Treasury a mechanisms for screening Opportunity Funds in an even more substantive manner; as evidenced by the fact that the TCJA's accompanying Conference Report stated that *"the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit."*

New Markets Tax Credits are allocated through an annual competitive application process, one which helps ensure that the most qualified entities are provided with credit allocations, and that the scarce credits are directed to the highest and best uses. While it is not feasible to hold competitions among Opportunity Funds in the manner that entities apply for NMTCs, Treasury could certainly consider employing some of the best practices from its NMTC review process into its Opportunity Fund certification review. For example, through the NMTC allocation process, entities are encouraged to commit to more rigorous outcomes as a condition of receiving an allocation, and then are held to these commitments as part of their allocation agreement. These include, among others:

- targeting investments in areas of severe economic distress;
- offering below-market rates and terms to their borrowers;
- investing more than the minimally required 85% of the NMTC investment proceeds into their low income communities;
- financing (if applicable) affordable housing; and
- making "innovative" investments, including investments in small businesses.

In addition to these provisions, which become a compliance requirement of the NMTC allocation agreements, applicants also receive higher scores for being able to demonstrate a likelihood of achieving significant community impacts, such as: creating high quality jobs; providing goods and services to low income community residents; financing minority-owned businesses; and ensuring environmentally sustainable outcomes.

As noted previously, LISC does not suggest imposing a competitive scoring and selection process on the certification of Opportunity Funds. This would be an unwise use of resources (both Federal and private sector) and would cause considerable delays in program implementation. In addition, this program needs to be flexible and attuned to market to be able to attract capital gains investors. However, as provided for in the Conference Report, we do think it would be appropriate for the Treasury Department to require Opportunity Funds to identify, at the time of certification, at least one outcome from a list of desirable outcomes that they will commit to achieving with their investments.

The desirable outcomes could be drawn from the NMTC selection items above, or could be broadened to include additional items that may be more relevant to the intentions of the Opportunity Zone program; for example, providing working capital and equipment capital to start-up businesses. Applicants would indicate their chosen outcomes through self-certifications at the time of the certification application, which could then be reviewed during a compliance audit after the investments have been made.

Recommendations

As noted earlier, the Opportunity Zone initiative is still very early in its program implementation phase. While it is notable that Opportunity Zone designations have been submitted by all states and territories, and that final approvals are expected by the end of this week, this only marks the end of the first phase. As detailed further below, this needs to be followed up with continued oversight and support from Congress; timely guidance and/or rulemaking by Treasury to ensure that the objectives of the program are being met; and significant involvement from states and municipalities to attract investment capital into their designated Opportunity Zones.

1. **Congress should consult closely with the Treasury Department during their next phase of rulemaking, to identify whether there are areas that may require statutory fixes.**

   For example, there may be some barriers to making equity investments in businesses through the Opportunity Fund structure. A traditional private equity fund holds and liquidates investments at different times over a number of years and the proceeds from the disposal of each investment are distributed to its investors, or recycled into substitute investments. Under this traditional private equity arrangement, it is unclear how an investor could attain the ten-year benefit of gain exclusion on the sale of qualified opportunity zone property, since any gains realized by the Opportunity Fund when it liquidates an investment will be taxed to the Opportunity Fund (in the case C-corporation) or will flow-through to the individual investors in the Opportunity Fund (in the case of a partnership).

   In other words, there does not appear to be a readily available mechanism for reinvesting capital without triggering a tax event. Congress may need to provide relief for gains realized on the sale of an appreciated qualified opportunity zone property before the end of a taxpayer's 10-year holding period, provided that the proceeds of a sale are reinvested in replacement projects within a reasonable period.

   Another area where a technical fix may be useful relates to the timing of investments, and the requirement that 90% of Opportunity Fund investments be made in qualifying businesses in Opportunity Zones. Specifically, in the case of real estate investments, consideration should be given to allowing Opportunity Funds to invest in projects as certain construction benchmarks are met, perhaps over a 24 month investment period.

   These are but two examples of where a technical fixes may be necessary. Others are likely to arise as the IRS begins writing regulations. It is important that the IRS and Congress communicate on these issues.

2. **Treasury and the IRS should play a more active role in program implementation and administration.** Treasury has thus far not shown an inclination to get involved in any aspect outside of the technical guidance, despite implicit, if not explicit, authority to do so. Our recommendations for Treasury and the IRS are as follows:

a. Ensure a more robust certification of Opportunity Funds. The certification of the Opportunity Funds can still be done through a self-certification form, but the form should include a series of certifications and assurances to weed out potential bad actors, and as discussed earlier, should identify prospective community development outcomes that the Opportunity Fund anticipates achieving.

b. Certify the Opportunity Funds prior to investments being received and placed. It would appear as though the IRS does not intend to collect any information about the Opportunity Funds until investments have been made. We believe that Treasury should at least play some role in vetting these funds. Additionally, this would allow Treasury to collect baseline information about the organizations (e.g., the markets they intend to serve; the types of businesses in which they intend to invest) that could then be used to create a clearinghouse that investors and businesses could access to identify opportunities for investments in their markets.

c. Collect and disseminate data from the Opportunity Funds. The Treasury Department ideally will collect significant data from the Opportunity Funds, not just to ensure program compliance, but also to be responsive to the type of report that was envisioned in the Conference Report that accompanied the TCJA:

> *The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.*

We recommend that this information be collected by the Treasury Department on an annual basis via an electronic portal. While it may take some time for the Treasury Department to set up these systems, Opportunity Funds should be made aware of the data points that Treasury intends to collect at the time they are certified; ideally by including these data points as part of the certification form.

d. Solicit public comments on IRS rulemaking. In order to identify potential regulatory issues that need further clarification, IRS should move quickly to develop an Advanced Notice of Proposed Rulemaking or similar vehicle for collection of public input; rather than waiting to identify such issues after the drafting of a proposed rule, especially given the need for funds to invest in projects in 2019 in order to get the full benefits of the reduction in capital gains by 2026.

3. **States and municipalities should work with private sector partners to tap into new pools of investor capital (e.g., through private wealth managers), and should also make best efforts to steer Opportunity Zone investments into business and projects that will provide the most benefit to low income communities and their residents.** In addition to helping tap a pool of socially-responsible investors, states could create their own incentives for such investments. States could, for example, provide state tax incentives alongside the Opportunity Zone incentives, but only for projects that it deems will satisfy critical community development objectives (e.g., start-up capital to small businesses; business creating quality jobs; development of affordable housing; development of community facilities; etc.). Similarly, states could align existing development programs with Opportunity Zone geographies. For example, to help ensure the production of affordable housing in these geographies, state housing finance agencies could, through their Qualified Allocation Plans, state a preference for housing credit developments to be located in Opportunity Zones; and could also direct their Housing Trust Fund dollars and HOME dollars to projects in Opportunity Zones.

Conclusion

We believe the Opportunity Zones initiative has tremendous potential to attract new investment capital into low income urban and rural communities. Though still early in the implementation phase, there is already great energy in the community development sector in support of this program. With strong continued leadership from Congress and the implementation of our recommendations herein, we believe that the Opportunity Zones incentive can spur billions in private investment activity in the country's most distressed census tracts and play a major role in closing the existing opportunity gap that is leaving these communities behind.