Module 2

Fundamentals of Opportunity Zone Investing

Module Summary

Opportunity Zones
CHARTER SCHOOL PROGRAMS

U.S. Department of Education
Office of Elementary and Secondary Education

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Impact investing overview

Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return. Impact investments are made in both emerging and developed markets and target a range of returns from below market to market rate, depending on investors' goals for financial returns, impact returns, and learning returns.

There are generally three types of impact investors: investors that require market rate return for their capital while generating positive social impact; investors that can accept a lower return on their capital; and high-net-worth individuals, families, and foundations that invest for social impact with varying expectations for returns.

There are two major categories of tools impact investors leverage. The first set includes traditional financing tools such as equity or cash, loans, debt financing, and bond issuance. Investors may invest with both equity and debt, but the composition of the different tools and sources used will vary by different interest rates of debt, time constraints of different tools, opportunity cost of equity or cash, and the project risk. The second set of tools common to impact investors includes government tax incentive programs such as the federal New Markets Tax Credit and the Low-Income Housing Tax Credit.

Impact investment is a growing field and the rate of return for these investors falls along a spectrum, from market rate return to zero or sometimes negative returns.

Opportunity Zone history and description

In 2018, governors nominated up to 25 percent of a state or territory's low-income community census tracts for Opportunity Zone (OZ) designation. Governors were given flexibility in their nominations to balance opportunity and need, as well as the historical and projected trends in those tracts. Nominations were then reviewed by the U.S. Treasury, and a total of 8,700 tracts were designated as OZs.

OZ investments must be made through a Qualified Opportunity Fund (QOF), which is a private investment vehicle certified by the Treasury to aggregate and deploy capital in OZs for eligible uses defined as Opportunity Zone Property. Qualified Opportunity Zone Property is limited to 1) interests in a partnership that operates as a qualified business in an OZ; 2) Stock ownership of qualified businesses whose operations are based mostly or entirely within an OZ; and 3) property, such as real estate, located within an OZ.

Any taxpaying individual or entity can create a QOF through a self-certification process. The fund must hold at least 90 percent of its assets in qualifying Opportunity Zone Property. To qualify as an eligible Opportunity Zone Business, a business must demonstrate that all its tangible business property is substantially located within an OZ.

Benefits of the Opportunity Zone incentive

There are three major tax benefits of the OZ program for investors. First, it provides a temporary deferral of inclusion in taxable income for capital gains reinvested in a QOF. Rather than paying taxes when capital gains are realized, for example, in 2021, investors can wait to pay those taxes until 2026. Second, it offers a step-up in basis for capital gains reinvested in a QOF. With this benefit, investors do not need to pay taxes on 10 or 15 percent of their capital gains. Third, the program allows a permanent exclusion from taxable income of new capital gains from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years.

Most census tracts designated as OZs have a higher poverty level, lower education attainment, and a higher share of population of color than other census tracts in their state. Aligning social impact goals with the needs of these communities can be an important consideration and benefit for OZ investors and impact investors. Areas of social impact in community development to consider include accessible and high-quality jobs, community wealth building, affordable and accessible housing, environment and open spaces, health, social services, cultural amenities, and transportation. By providing students with a high-quality education, charter schools can contribute to social impact. In addition, schools can provide or link families to other health or social services.

Opportunity Zone projects

A typical OZ-financed project may include partners such as the developer, the QOF manager, an anchor tenant for the development, legal and accounting service providers, and a local economic development agency or other government partner. In addition to OZ equity, the deal may include a construction lender; federal, state, or local subsidies; and state or local incentives or abatements.

Benefits of having OZ financing in the deal include the tax benefits investors receive on the equity capital used to support the project; its use as a gap filler in the capital stack[1]; and the fact that it can reduce or eliminate the amount of owner equity needed for a project. OZ financing can also have an impact by advancing projects with a gap in the capital stack; by reducing or eliminating the need for owner equity, allowing the owner to preserve equity on their balance sheet; and by replacing other sources of expensive debt financing, which may result in project cost savings. In addition, locating a project in an OZ can strengthen the project's ability to attract other sources of financing and/or government subsidies and incentives.

An example of a recent OZ deal is the Plank-Calumet/Oswego Mixed-Use Development, which sought to replace an underutilized property in an area of Baton Rouge, Louisiana that was suffering from concentrated blight and vacancy[2]. As part of a larger redevelopment plan finalized in 2019 after a year-long urban planning community engagement effort, the mixed-use development will include a YWCA early childcare center. The community will benefit from expanded high-quality, affordable childcare co-located with housing and a mission-aligned nonprofit. Total development costs were estimated at $10.9 million; this was financed with $3 million in equity, $2.9 million in debt, $2.5 million in federal grants, and $2.5 million in other grants and credits. Financers took advantage of OZ incentives in this deal.

[1] The capital stack is the organization of all capital in a real estate transaction. It also provides the structure for the order of rights to receive income and profits from the property.

[2] For more information on this project, see https://theopportunityexchange-production.s3.amazonaws.com/static/media_files/Plank_Calumet_Development.pdf

Review Questions

Answer these questions to check your understanding of this module. The section name above a set of questions refers to the section of the videos and the module summary where you will find the information.

Impact investing overview

1. What distinguishes an impact investor from a traditional investor?

2. Do all impact investors require the same rate of return?

Opportunity Zone history and description

3. When were Opportunity Zones created?

4. Who selected which eligible census tracts to be designated as Opportunity Zones? (Select one.)

☐ Governors ☐ Congress ☐ Federal government

5. Who can create a Qualified Opportunity Fund?

Benefits of the Opportunity Zone incentive

6. Describe the three benefits of the OZ program for investors.

7. What demographics do OZs typically have compared to other census tracts in the state? (Select one.)

☐ Higher income and educational attainment

☐ Lower income and educational attainment

☐ There is typically no difference

Opportunity Zone projects

8. What types of partners are typically involved in an OZ-financed deal? (Select all that apply.)

   ☐ Developer ☐ Anchor tenant(s) ☐ Local government agencies

   ☐ Federal government agencies ☐ Legal and accounting services providers

   ☐ Qualified Opportunity Fund manager ☐ Opportunity Zone manager

9. Describe some benefits of including OZ financing as part of a project deal.

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10. What was the YWCA early childcare center's role in the OZ deal described?

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