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Enhancing Housing Affordability through Opportunity Zones

Jill Homan, Shafron Hawkins, and Aaron Hedlund

TOPLINE POINTS

- Bipartisan support exists for harnessing the Opportunity Zones policy created by the 2017 Tax Cuts and Jobs Act to tackle the housing affordability crisis.
- Recent evidence already finds that Opportunity Zones are boosting housing supply across America, which is the cornerstone of boosting affordability.
- Broadening investment eligibility, increasing the number of eligible census tracts, creating add-on incentives for housing investments, and incentivizing state and local deregulation are potent ways to use Opportunity Zones to boost affordability.

Introduction

The 2017 Tax Cuts and Jobs Act created the Opportunity Zones (OZ) program, which designated nearly 8,800 distressed communities (census tracts) across America as OZs. The program offers robust tax incentives to people who roll over capital gains from prior investments into Qualified Opportunity Funds (QOFs) that invest in businesses and properties in OZs. In January 2021, when Sen. Tim Scott (R-SC), the Senate's most ardent OZ champion and then Ranking Member on the Senate Banking Committee, questioned Secretary of Housing and Urban Development nominee Marcia Fudge about the policy, she indicated that she would like to see OZs used to expand affordable housing across America. This brief will provide strategies and reforms that lawmakers can pursue to empower the OZ program to enhance housing affordability.

The current OZ tax incentives include multiple components:

1. Deferral of an investor's original capital gains tax liability until they exit the OZ investment or December 31, 2026, whichever comes first.
2. A "step-up in basis" (reduction) on their original capital gain tax liability of 10 percent if they hold the new investment for five years, rising to 15 percent if they hold the new investment for seven years.

3. A waiving of all capital gains taxes on appreciation from the new investment once it is held for 10 years.

The widely recognized definition in industry, academic, and policy circles of affordable housing is that occupants pay no more than 30 percent of their pretax income on housing costs. Thus, if a family in Cleveland, Ohio, has an income of $37,000 per year, then rent over $925 would be considered unaffordable.

Harnessing OZs to Enhance Affordability

There is already robust evidence that OZ tax incentives are increasing the housing supply, which is the crux of improving affordability. A recent working paper using American Communities survey data concluded that OZ designation has increased both housing values and supply but held rents steady (Wheeler, 2022). The paper found that "rents and home values trend comparably in OZs and eligible non-OZs prior to the program." However, the paper concluded that after the incentive took effect, values increased within OZs, but rents did not. These effects are notable in light of OZ detractors warning of widespread "gentrification" in OZs.

The study seems to confirm what any student of economics would expect. If you increase the supply of housing to meet demand better, the price will fall or rise more slowly depending on the amount of additional supply produced.

Increased building and rehabilitation in OZs have helped increase the value of residential property in designated areas, but the supply created by new development has held rents stable. Wheeler (2022) found that OZ designation led to a 3.4 percent increase in median home value in designated communities from 2017 to 2020. A growing body of literature on the relationship between local housing supply and rental affordability has reinforced these findings (Lettieri, 2021).

Options to enhance the ability of OZs to tackle the housing affordability crisis, as shown below, could be pursued individually or in combination.

Prescription 1: Altering the "Substantial Improvement" Threshold

One strategy OZ investors may use to qualify real estate as an OZ investment is "substantially improving" a newly acquired building in an OZ. The threshold for substantial improvement is doubling the basis (the amount paid to purchase the property, not including the land). The policymakers crafting the OZ policy did not want investors to benefit from simply purchasing existing property in a distressed neighborhood without making significant improvements to the property.

As an example, if an investor buys a building in an OZ for $1,500,000 and the land value is $500,000, then the investor must spend more than $1,000,000 improving the building (making the total investment in the deal more than $2,500,000) for that building to be OZ-eligible. In many cases, such an onerous requirement would be cost-prohibitive or financially unsound. At the same time, this requirement excludes many promising investments.

Lawmakers can expand the stock of affordable housing by eliminating the 100 percent substantial improvement requirement on OZ projects that meet a given affordability threshold. Some buildings can be rehabilitated for less than 100 percent of the building purchase price. A substantial improvement threshold of less than 100 percent for affordable housing would mean lower project costs and, thus, lower rents.

One possible reform is to harmonize the OZ substantial improvement requirement with that found in the Low-Income Housing Tax Credit (LIHTC) program. Created by the Tax Reform Act of 1986, the LIHTC program gives state and local LIHTC-allocating agencies about $10 billion in annual budget authority to issue tax credits for the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households. When properties are acquired and rehabilitated under LIHTC, a substantial improvement threshold must be met, which is the greater of $6,800 per unit or 20 percent of the adjusted cost basis of the property. Reducing the substantial improvement threshold for OZ *affordable housing* investments (i.e., not *all* investments) would allow OZs to unleash a wave of housing investment.

Prescription 2: Expanding the OZ Map for Investments in Housing Affordability

Currently, only qualified investments in census tracts officially designated as OZs can benefit from OZ tax incentives. However, because of limits in the number of census tracts that governors could nominate, many other struggling and housing-burdened non-OZ communities remain.

Lawmakers could expand the OZ map by extending the OZ incentives to affordable housing investments located in census tracts that satisfy the following three-pronged test:

(1) Median household income in the tract is below the median income in the broader region.
(2) Median rents exceed 30 percent of median income in the census tract.
(3) Governments operating in the census tract make adequate progress in easing the regulatory burden on construction and other activities that boost housing supply.

This last point is particularly worth emphasizing. Many impediments to housing affordability occur at the state and local level through onerous regulations that increase the cost and difficulty of building. Including the third criterion for expanding the OZ map would ensure better stewardship of federal taxpayer dollars by not wasting valuable tax incentives meant to expand the housing supply in areas that are actively undermining the ability of the private sector to create that supply via excessive regulation. Moreover, as citizens and would-be investors in high-regulation communities realize they are missing out on stronger gains, they are likely to pressure their elected officials to cut red tape.

Prescription 3: Extra Strength OZ+ Incentives to Boost Housing Investment and Reward Deregulation

Federal lawmakers could strengthen the OZ tax incentives beyond their baseline level for high-impact types of investments, such as those that boost the supply of affordable housing. For example, stronger “Opportunity Zone Plus (OZ+)” incentives could entail an even larger step-up in basis and relaxed criteria for the amount of time that money must remain in QOFs to receive the OZ tax benefits. The strengthened OZ+ incentive could further boost housing supply by allowing communities to receive an OZ “easy-to-build” badge if they achieve sufficient progress in deregulating their housing markets and making it easier to build. This OZ badge could either be a *necessary* condition for affordable housing investment to qualify for the stronger OZ+ incentive, or the OZ badge could trigger an *even stronger* OZ++ incentive for affordable housing investments. The table below outlines how each of the two options would work.

Option 1 (Two Tiers)	Option 2 (Three Tiers)
OZ+ incentive: affordable housing investments in communities that earn an OZ easy-to-build badge through sufficient housing deregulation. Baseline OZ incentive: all other OZ investments.	OZ++ incentive: affordable housing investments in communities that earn an OZ easy-to-build badge through sufficient housing deregulation. OZ+ incentive: affordable housing investments in OZs that do not earn an OZ easy-to-build badge. Baseline OZ incentive: all other OZ investments.

If prescriptions 2 and 3 went into effect, qualified, affordable housing investments would receive the same incentives whether they were located in an OZ or in a census tract that satisfies the three-pronged test above.

Conclusion

OZs are a pro-growth, private sector-driven solution to expanding economic supply in a number of critically important areas, with housing rising to the top of the list of concerns. Renewing OZs and making targeted reforms is a pivotal component to an overall strategy to restoring housing affordability and the homeownership dream.

WORKS CITED

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