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Expanding Rural Opportunity Zone Investment

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TOPLINE POINTS

- The 2017 Tax Cuts and Jobs Act created the Opportunity Zone program, which is a tax incentive that has proven instrumental in attracting $84 billion and counting in private investment to distressed communities across America.
- To build upon this success, policymakers can streamline and improve the tax incentive to encourage more robust investment in rural areas and greater transparency and accountability.
- Clearing the way for "feeder funds" and "fund-of-funds" models would greatly expand the pool of available investment while reducing the substantial improvement threshold would enable this money to be used across a greater array of projects.
- Expanding the number of rural Opportunity Zones would also facilitate the strengthening of distressed communities in areas with lower population density.

Background

The Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97) created a new tool for community development called Opportunity Zones (OZs). These zones aim to reinvigorate struggling communities through tax incentives to encourage greater private investment.

The law provides a range of tax benefits to investors who roll over capital gains from prior investments into new entities called Qualified Opportunity Funds (QOFs) that deploy capital into businesses operating in economically distressed communities designated by the governor. It allowed the governor of each state or territory to designate 25 percent of the state's economically distressed communities (census tracts) as OZs (or a total of 25 census tracts if the state had less than 100 low-income communities). Nearly 8,800 census tracts have seen tens of billions of dollars in equity investment in total.

The first OZ benefit to investors is a tax deferral on their original capital gains. As originally designed, OZs also incentivize long-term investment in distressed communities by reducing the amount of tax on the investor's original capital gain through a step-up in basis if the investor keeps funds in the QOF for at least five years. At the five-year mark, the step-up in basis is 10 percent, and it rises to 15 percent at the seven-year mark. Investors that keep their funds in a QOF for 10 years not only receive the step-up in basis on their original capital gain, but they also face *zero tax* on the gain generated by the OZ investment itself.

As of 2022, the OZ tax incentive has successfully attracted more than $84 billion (Joint Committee on Taxation, 2024) in private capital to struggling and forgotten communities, causing a surge of employment growth, increasing home values, and alleviating pressure on rents through greater market-rate residential development.

To build on this success, OZs can be streamlined and improved to encourage more robust investment in rural areas and greater transparency and accountability.

Make Opportunity Zones More Transparent

Congress can improve rural OZ investing by enacting reporting and transparency requirements such as those found in the Small Business Jobs Act introduced in 2023 and largely mirrored in the Opportunity Zones Transparency, Extension, and Improvement Act from 2022. Without creating a significant burden for OZ funds, investors, and stakeholders, both bills would enable more robust data collection—beyond the current requirements of just the amounts invested and the percentage of a state's census tracts that saw investment. While bipartisan, bicameral reporting and transparency legislation has been introduced, nothing has passed Congress to date.

The Small Business Jobs Act would enable the Department of the Treasury to collect key information on the location of OZ investments, the types of businesses and projects attracting investment, and the number of jobs created. This information would enable Congress to adjust the policy to further incentivize investment in underserved areas and demonstrate the viability of the policy as a community development tool. Such data would be very beneficial in the case of rural OZs, which represent about 23 percent of designated census tracts and receive a disproportionately smaller share of investment than urban tracts. These proposed requirements have been carefully crafted and have bipartisan support on Capitol Hill and widespread support among OZ stakeholders.

Jumpstart Investment in Rural Communities and Operating Businesses

Investment in smaller cities and rural areas may be more likely to support non–real estate operating businesses, and targeted improvements to the OZ policy would help facilitate even greater levels of investment in such areas. For example, smaller impact-oriented funds often have difficulty raising capital. Allowing intermediary investments into "feeder funds" could help resolve this issue by broadening the base of potential investors and enabling them to pool capital. A "fund-of-funds" model streamlines and broadens the process of OZ investing by allowing investment managers to pool capital and invest the money in someone else's fund that has already identified promising businesses. This model could drive more investment into rural communities, making efforts to expand the OZ map to include more persistently poor rural places even more effective.

Reduce the Substantial Improvement Threshold in Rural Opportunity Zones

For existing business property acquired by a QOF to be eligible for OZ tax incentives, business owners must make substantial improvements to the property sufficient to increase its value relative to the initial purchase price (excluding land) by at least 100 percent over 30 months. However, there are buildings in rural areas that can be rehabilitated for less than 100 percent of the building purchase price, especially given likely lower labor and construction costs than those typically in urban areas. Moreover, operating businesses in rural OZs can create jobs and spur growth without an investment of 100 percent of the purchase price. Thus, the current 100 percent requirement makes many valuable investments OZ-ineligible. Congress can address this issue and incentivize investing in rural OZs by reducing the 100 percent substantial improvement requirement—for example, to 50 percent—on projects in rural OZs.

Expand the Number of Eligible Rural Opportunity Zones

Expanding the number of eligible rural OZs would attract more capital to these communities. A state could designate an additional 10 percent of its census tracts as OZs, provided that the total share of rural tracts ends up exceeding an adequate threshold. An increase in eligibility would expand the potential options for investors and allow state governments to develop a suite of complementary legislation to incentivize growth.

In OZ investing, like any other investing, much of the early money will focus on "low-hanging fruit," where an investor can receive an appropriate return for the level of assumed risk. Urban areas often present advantages because investors can pair OZs with other familiar federal and state incentives. Nevertheless, OZ investing has proven to be broad-based and not confined to a few cities on the coasts. The solutions above could help attract even more investment to rural areas and lay the foundation for even more reforms to ensure a strong and prosperous rural America.

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