OPPORTUNITY ZONES

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Background on Capital Gains

- Capital gains are a component of total income, which forms the basis of Adjusted Gross Income.
- At the Federal level:
  - Taxed at different rates than ordinary income, rates range from 0 to 20%.
- At the Vermont level:
  - Any capital gain reported on the Federal Schedule D flows through to Vermont through AGI.
  - Vermont gives a capital gains exclusion
    - $5000 flat exclusion or 40% for any capital gain from sales of businesses, investment properties or farms. 40% exclusion is limited to $350,000 ($875,000 in gains)
- In TY2016, almost 42,000 VT taxpayers reported capital gains totaling just over $1 billion in gains.
  - Capital gains account for 8-12% of personal income tax revenues each year.

Opportunity Zones Background

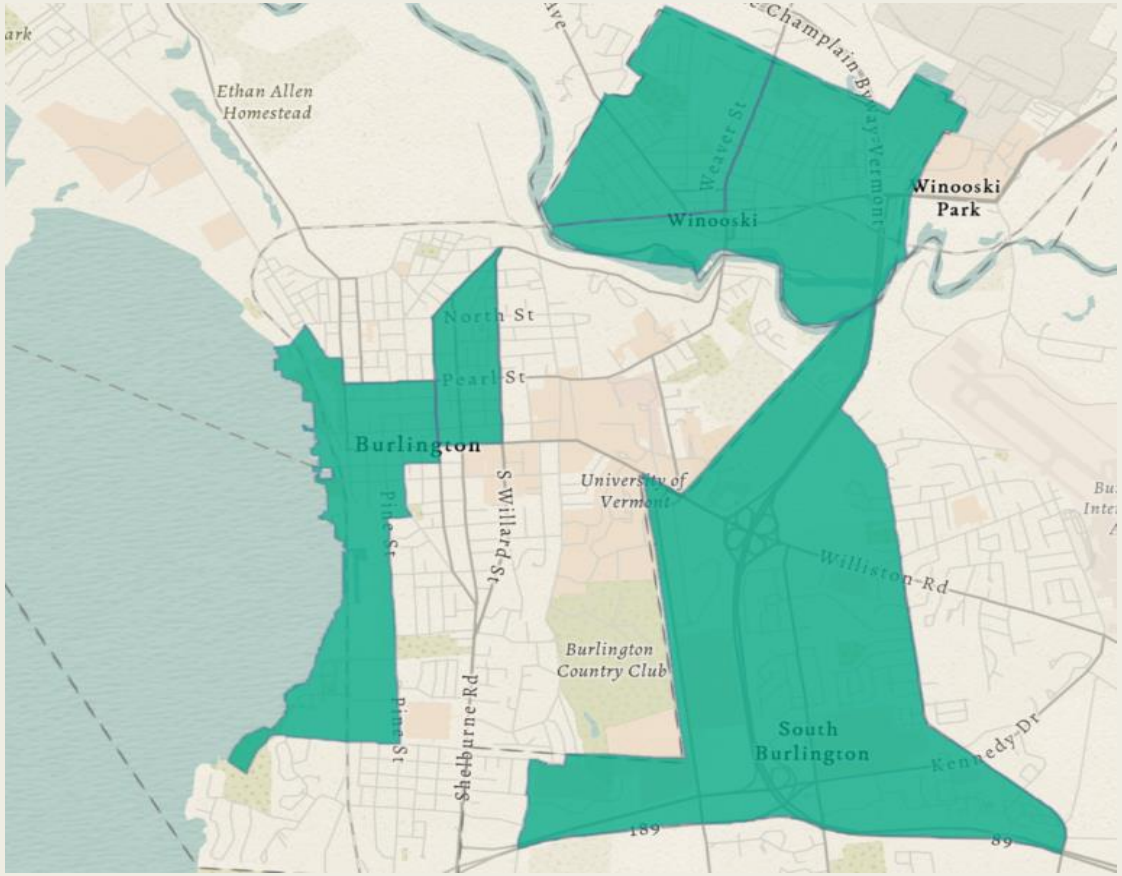
- Created in the 2017 Tax Cuts and Jobs Act
- A tax incentive designed to drive investment to economically-distressed areas.
- A basic overview on how it works:
  - *1) States designate Opportunity Zones*
  - *2) Developers or investors create Qualified Opportunity Funds (QOFs)*
  - *3) Investors place previously-realized capital gains (and/or other capital) into the QOFs*
  - *4) QOFs are used to finance investments (either real estate or businesses) in the Opportunity Zones*
  - *5) Investors in the QOF receive tax benefits for their investments depending on how long they hold onto their investments*

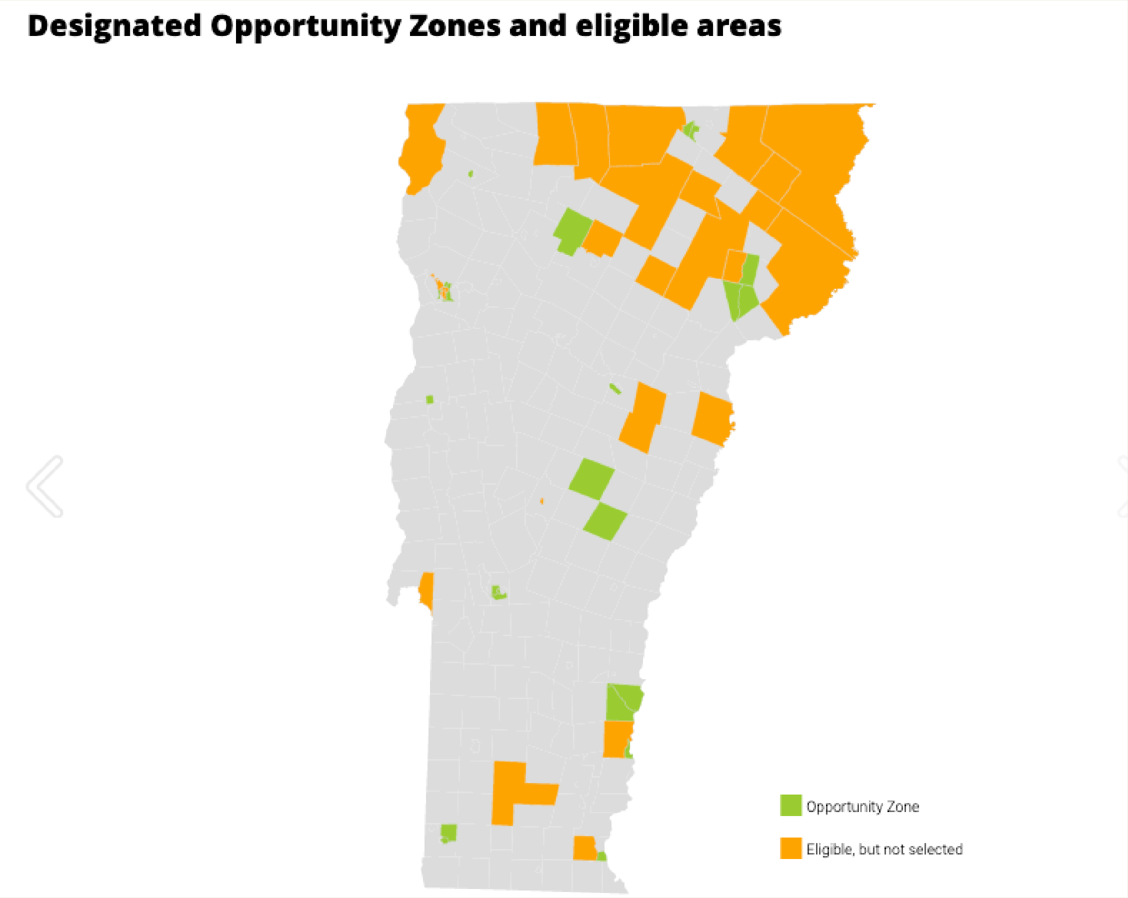
How are Opportunity Zones designated?

- Must be a census tract meeting the following characteristics:
  - *Poverty rate of at least 20% or*
  - *Median income below these thresholds:*
    - For non-metropolitan tracts: not more than 80% of the statewide median income
    - For metropolitan tracts: not more than 80% of the statewide median income or the overall metropolitan median income for the metro areas in the state.
- Other potential way to qualify:
  - *Be a census tract that is contiguous with a low-income OZ and have median income not more than 125% of the median income in the adjacent OZ*
- 57% of all census tracts in America qualify. 12% of total US census tracts were designed as OZs

Vermont's Opportunity Zones

- Vermont has 25 designated Census-tracts as OZs





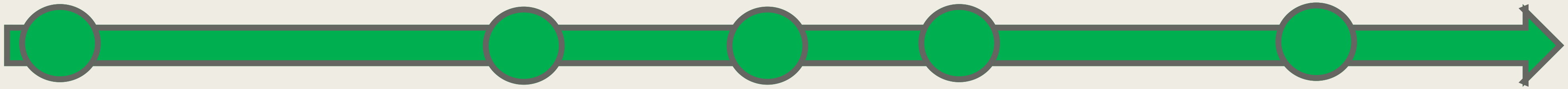
Sources: VTDigger, Donahue and Associates

OZ Tax Benefits

- Opportunity Zones have three main tax benefits:
  - Deferral on realized capital gains taxes if the gains are placed into a QOF within 180 days of realization
  - If the previously-realized capital gain is held in the QOF for at least 5 years, the basis on that gain is stepped up 10%. If they hold it in the QOF for 7 years, the basis is stepped up 15%.
  - For those who hold their funds in an QOF for 10 years or longer, any appreciation on the investment is exempt from capital gains taxes.

OZ Tax Benefits

April 2027
Pay taxes on the original deferred capital gain (with stepped up 15% basis)



2019, Year 1
Roll over previously-realized capital gain into QOF

2024, Year 5
Basis on original capital gain is stepped up 10%

2026, Year 7
Basis on original capital gain is stepped up another 5%

2029, Year 10
All capital gains taxes are exempted on any appreciation on the original investment in the QOF

What is the flow-through channel to VT?

- The taxpayer notes the deferral and exemption as part of their IRS Schedule D. The amount is then excluded from their capital gains total.
  - For example, if a taxpayer had a total of $1 million in capital gains, but $800,000 were invested in an OZ, then the taxpayer would only report $200,000 in capital gains for 2019 as part of their total income.
- Total income → AGI → starting place for Vermont

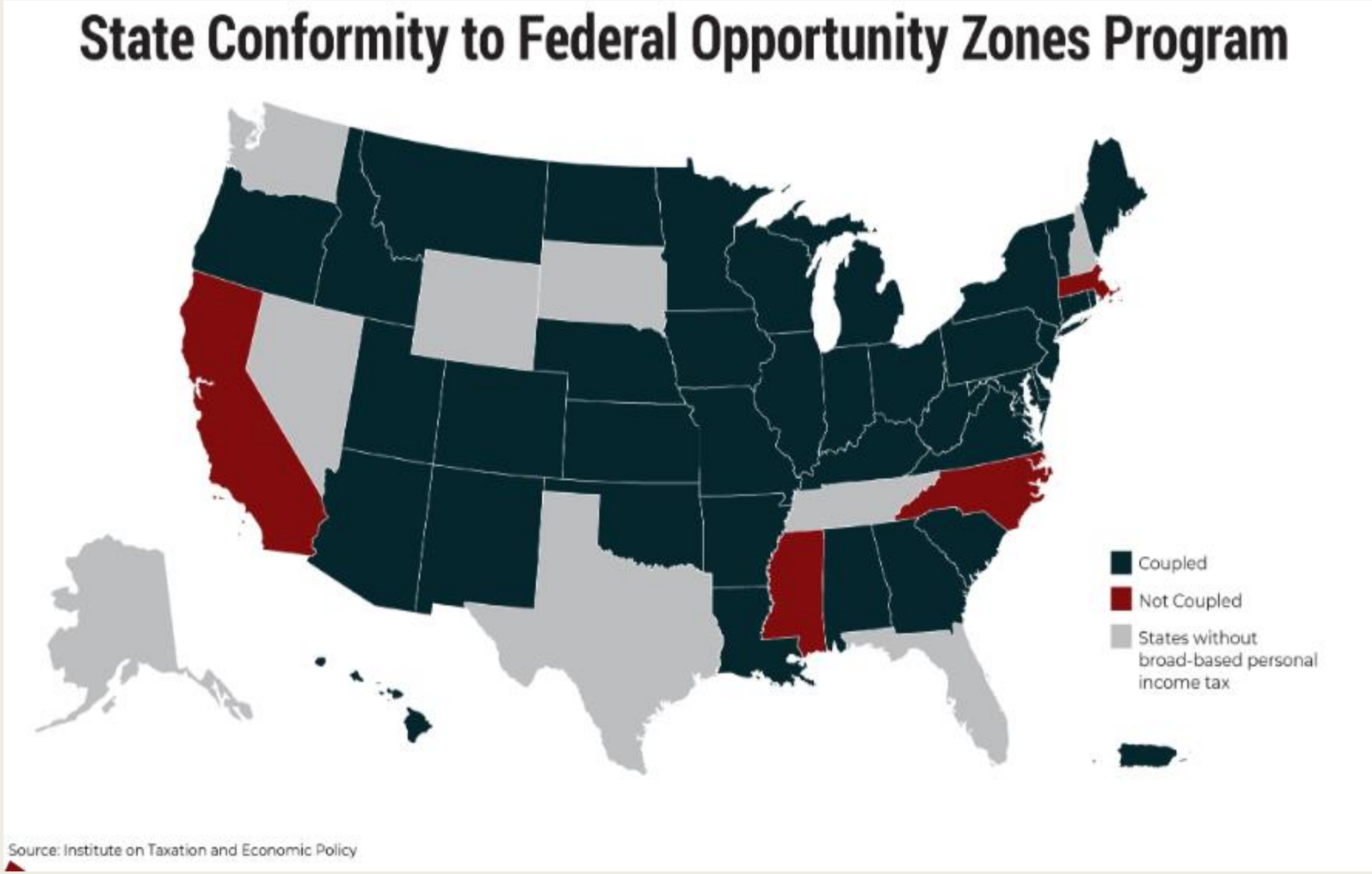
Standard Deduction for—
- Single or Married filing separately, $12,200
- Married filing jointly or Qualifying widow(er), $24,400
- Head of household, $18,350
- If you checked any box under *Standard Deduction,* see instructions.

1	Wages, salaries, tips, etc. Attach Form(s) W-2				1
2a	Tax-exempt interest	2a		b Taxable interest. Attach Sch. B if required	2b
3a	Qualified dividends	3a		b Ordinary dividends. Attach Sch. B if required	3b
4a	IRA distributions	4a		b Taxable amount	4b
c	Pensions and annuities	4c		d Taxable amount	4d
5a	Social security benefits	5a		b Taxable amount	5b
6	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				6
7a	Other income from Schedule 1, line 9				7a
b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your **total income** ▶				7b
8a	Adjustments to income from Schedule 1, line 22				8a
b	Subtract line 8a from line 7b. This is your **adjusted gross income** ▶				8b
9	**Standard deduction or itemized deductions** (from Schedule A)	9			
10	Qualified business income deduction. Attach Form 8995 or Form 8995-A	10			
11a	Add lines 9 and 10				11a
b	**Taxable income.** Subtract line 11a from line 8b. If zero or less, enter -0-				11b

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2019)

What have other states done with OZs?

- Most states are coupled, like Vermont
- Four states have decoupled
- Some states have provided enhanced tax benefits
  - *MD and LA have provided additional property tax relief in OZs*
  - *AL, AS, CT, OH have provided additional state investment tax credits to investments in OZs*
  - *RI provides additional CG relief*



Outside analysis/commentary

- *New York Times:* "How a Trump Tax Break to Help Poor Communities Became a Windfall for the Rich", August 2019
  - https://www.nytimes.com/2019/08/31/business/tax-opportunity-zones.html
- *Center on Budget and Policy Priorities*
  - *"States Should Decouple Their Income Taxes From Federal "Opportunity Zone" Tax Breaks ASAP"*
  - *"Opportunity Zones Exemplify 2017 Tax Law's Fundamental Flaws"*
  - *"Opportunity Zone Regulations Favor Investor Flexibility Over Community Protection"*
- Heritage Foundation ("Opportunity Zones: Understanding Them in the Context of Past Place-Based Incentives" July 2019)
  - *"Academic and government studies show that past place-based development experiments often failed to yield promised employment gains or advance general economic opportunity for targeted residents"*
- Cato Institute: "O Zones are a bad idea and should be repealed" (September 2019)
- Sage, Langen et al, (2019): Prices of real estate increased within Opportunity Zones but not in properties adjacent to them, indicating that the tax benefits are "baked-in" to the price, but does not boost values in the community as a whole.
- Chen, Glaeser and Wessel (2019): The difference in price growth in homes inside OZs is not statistically different from those outside OZs, suggesting homebuyers don't believe the tax benefit will generate major development in the area overall.

Example

- 2019 Married taxpayer with the following income:
  - Total Income: $500,000
    - Non-capital gains income: $100,000
    - Capital gains income: $400,000
      - *Original basis: $100,000*
      - *Price when sold (fair market value): $500,000*
  - OZ investment yields an annual nominal rate of return of 5%
- Itemized Deductions
  - Mortgage Interest: $15,000
  - S&L Taxes: $10,000
  - Charitable contributions: $2,500
  - Other: $0
- Non-capital gains income, charitable contributions grow by inflation

Tax Benefits of Opportunity Zone Investment			
OZ Tax Deferral Benefits			
	Vermont	**Federal**	**Total**
2019 Taxes-No OZ	$21,378	$67,345	$88,723
2019 Taxes-CG are put in OZ	$3,077	$8,312	$11,389
Difference	*$18,301*	*$59,033*	*$77,334*
2026 Taxes if CG are withdrawn (in 2019 dollars)	$17,978	$58,557	$76,535
Tax Benefit of Deferral in 2019 dollars	**$3,400**	**$8,787**	**$12,188**
OZ Appreciation Tax Benefits			
	Vermont	**Federal**	**Total**
2029 Taxes-No OZ	$33,274	$107,152	$140,426
2029 Taxes-OZ	$20,068	$63,820	$83,888
Difference	*$13,206*	*$43,332*	*$56,538*
Tax Benefit of Exemption in 2019 Dollars	**$10,246**	**$33,620**	**$43,866**
Total Tax Benefit in 2019 Dollars	**$13,646**	**$42,407**	**$56,053**
as a percentage of 2019 AGI	2.7%	8.5%	11.2%

How much does this boost return?

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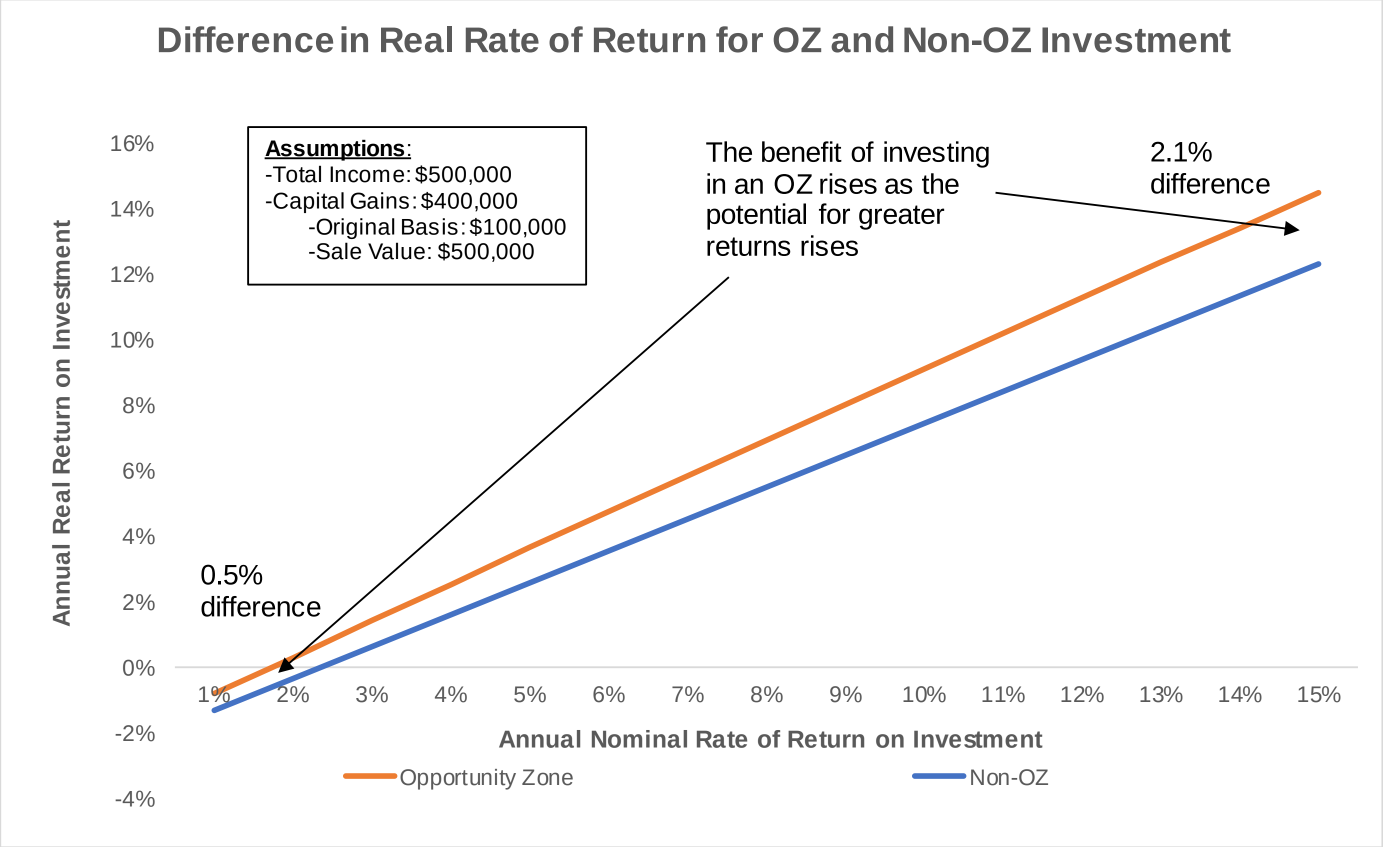
Real Investment Returns: OZ vs non-OZ		
	Opportunity Zone	Not OZ
Initial Total Investment	$400,000	$400,000
Value in 2029	$651,558	$651,558
Gain in 2029 Dollars	$251,558	$251,558
Real Return on Investment	$115,105	$115,105
Tax Savings in 2019 Dollars	$56,053	0
Total Return in 2019 Dollars	**$171,158**	**$115,105**
Total Real Return	43%	29%
Annualized Real Rate of Return (CAGR)	**3.6%**	**2.6%**

In most scenarios, the OZ benefit ranges from 0.5% to 3% per year

The OZ Benefit

- The “OZ Benefit” increases as:
  - **The rate of return on the investment rises**



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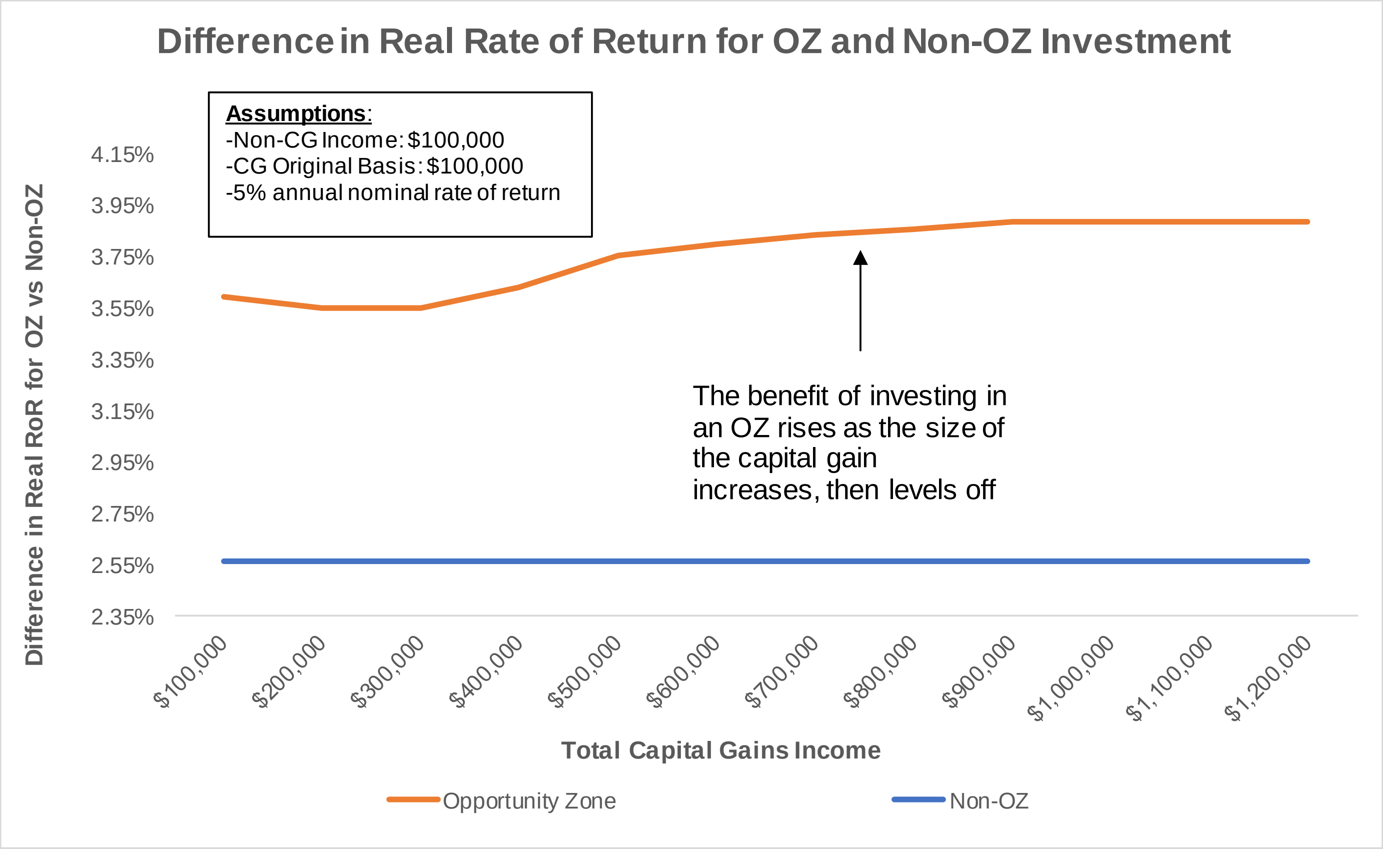
    - And therefore, 2019 income is higher
    - Note, OZ benefit levels off after $1m



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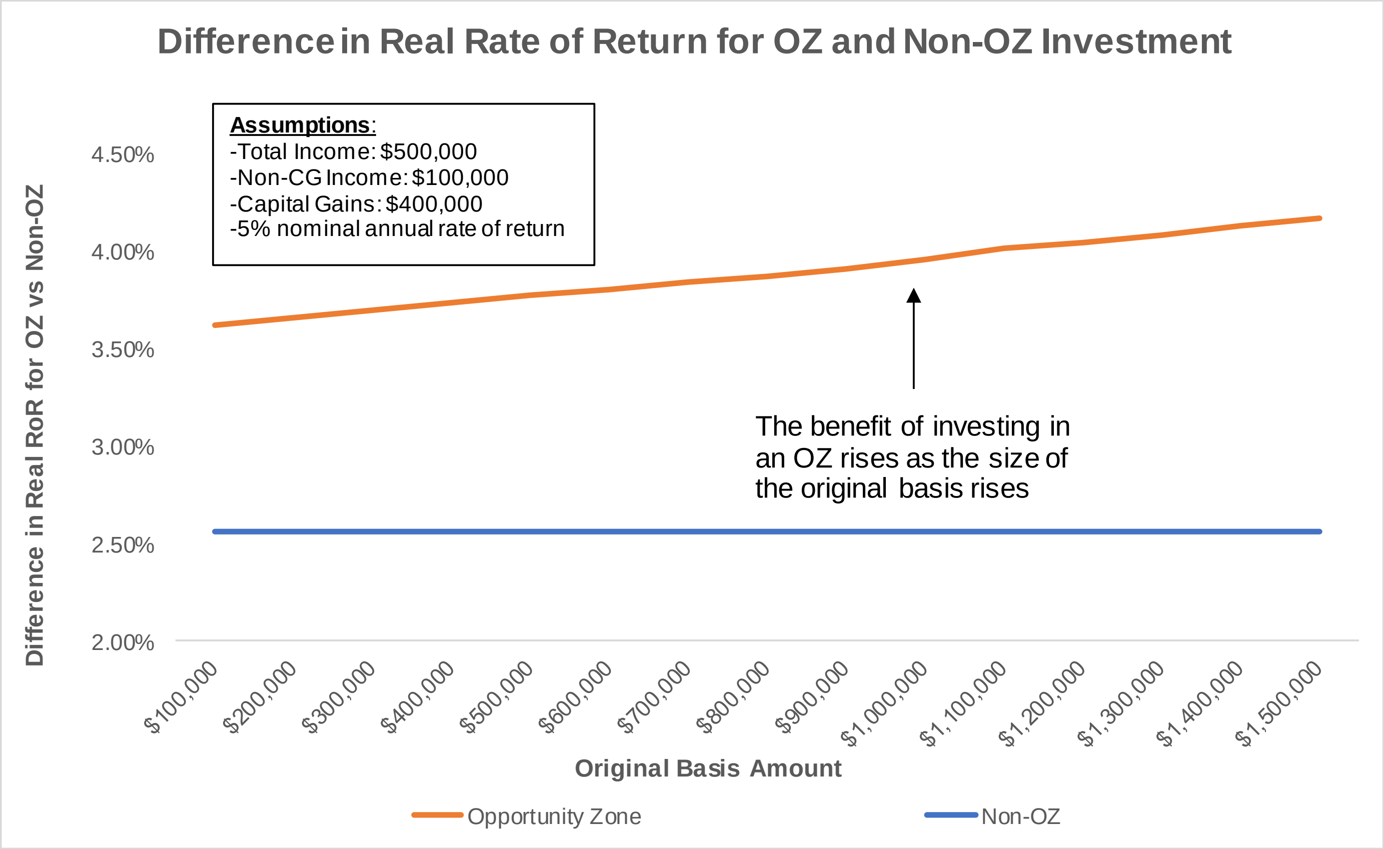
  - **The basis on the previously-realized capital gain is higher (in absolute dollars)**



Potential Revenue Loss

- Theoretically, the loss in revenue comes from three groups of taxpayers
  - *VT taxpayers who invest in VT Opportunity Zones*
  - *Non-resident taxpayers who invest in Vermont OZs with capital gains*
  - *VT taxpayers who invest in out-of-state Opportunity Zones with capital gains*
    - This is likely a smaller portion than the first two because of apportionment of gains
- Will depend on various factors:
  - *How popular will these be as an investment vehicle in Vermont?*
    - If they are popular, which OZs will see the most investment?
  - *Will the investments in Vermont OZs mostly come from in-state investors?*
  - *To what extent will Vermonters invest in out-of-state OZs?*
- JCT Estimate: -$1.7 billion in Federal taxes
  - Assuming effective Federal rates of 10 to 20% and effective VT rates of 5.25% and 7.35%, **a scaled VT estimate would be between $900,000 and $2.5 million in FY2021**
  - Part, but not all of this revenue loss will be offset by positive revenue bump in 2026