A dozen top state economic development officials have written two letters to Treasury, the IRS, and the regulatory authorities summarizing suggestions to ensure the new Opportunity Zone tax incentive delivers what both Congress and state governors have promised their constituents. This includes, summarized below, four key recommendations to ensure OZs fulfill the intent of Congress to attract scarce equity capital to underinvested communities for two purposes: the development of brick and mortar projects as well as the growth of operating businesses.

Opportunity Zones Must Work for Working Businesses

In the first quarter of 2018, we and our colleagues worked with our governors to designate our states' Opportunity Zones. This new federal tax tool has great potential. We take our responsibility to utilize this new tool to advance the economic development of our communities and the well-being of our citizens seriously. We selected zones based on the intent of Congress that this new federal capital gains tax incentive attract scarce equity capital to underinvested communities for two purposes: the development of brick and mortar projects as well as the growth of operating businesses. This program was not designed simply for investments in real estate. It was also created to foster entrepreneurial ventures, to strengthen manufacturers, to draw capital to businesses small and large, and to result in the production of jobs in these designated communities. As key stakeholders in the success of our states' Opportunity Zones, we want to ensure that the regulations the IRS delivers in the coming weeks reflect this same two-part intent.

The scale of need is vast. As recently as 2016, more than three-quarters of all U.S. counties still contained fewer places of business than before the recession, according to the Economic Innovation Group. On current trend-lines, the country's distressed zip codes are projected never to recover the jobs they lost to the Great Recession. The status quo would have investors continue to pour capital into the places already doing well. Opportunity Zone investments have the potential to disrupt that status quo by nudging investors to change behavior, take off blinders, and consider investing for the long-term in the future of places that have been left behind.

We and our peers – a dozen top state economic development officials – have written two letters to Treasury, the IRS, and the regulatory authorities summarizing our suggestions to ensure this new tax incentive delivers what both Congress and our governors have promised their constituents. We make four main recommendations.

First, Opportunity Zone investors should be able to invest in high-impact operating businesses that can generate jobs and wealth at scale by drawing revenue from outside of the community into it. Investors should be able to inject equity into manufacturers and e-commerce companies in addition to the restaurants and storefronts that also make up a community. For example, this means that the 50 percent gross income requirement should be interpreted to require that qualifying entities be active businesses as opposed to holding companies or patent boxes. It should not require that income be derived from a single point of sale in an Opportunity Zone, which would disqualify most, if not all, e-commerce companies, manufacturers, and other businesses with the potential to create significant numbers of new jobs and wealth for their communities. Additionally, we agree with the proposal that the definition of "substantially all" in reference the amount of tangible property a qualifying business holds in an Opportunity Zone be 70 percent. This approach will allow businesses the necessary operational flexibility to qualify for investments.

Second, the IRS and Treasury should reflect their understanding of the basic principles of investing equity into operating businesses by writing rules and regulations that allow Opportunity Funds--the required intermediaries for investment under this program --to develop a diverse investment portfolio. Such diversification is integral to success so that fund managers can spread out the risk from any one business failing. Such fund structures are more important than ever in the context of struggling communities where investment is by definition riskier and returns are by definition less certain. Allowing some initial flexibility in meeting the 90 percent asset test required of funds on a twice-yearly basis will allow Opportunity Funds the time required to put together a strong portfolio of qualifying investments, especially for funds interested in investing in operating businesses.

Third, Opportunity Funds should be able to buy and sell assets without incurring tax liabilities for their partners that would undermine the 10-year tax benefit. Specifically, the rules should allow funds to reinvest interim gains in a timely manner without incurring a penalty or triggering a taxable event. Successful investing requires a degree of nimbleness to react to new developments. Investors will be reluctant to commit to holding a stake in a single company for 10 years given all the forces that could intervene during that period. Investors should be able to divest from companies that are not succeeding as well as those that have as long as they keep their capital at work in Opportunity Zones. The IRS could consider establishing a minimum hold period for any individual investment in a zone. However, requiring a 10-year hold of each individual investment rather than a 10-year commitment to a fund will significantly undermine the ability to invest in operating businesses through the policy.

Finally, we encourage Treasury to adopt simple, unobtrusive reporting requirements to collect data on Funds and their investments. Such reporting will illuminate where the incentive has been successful and will help identify areas for improvement and modification in the future.

We recognize that finalizing new regulations is never as simple as it seems, but by working together, we are confident we can unleash the true potential of Opportunity Zones in these key communities.