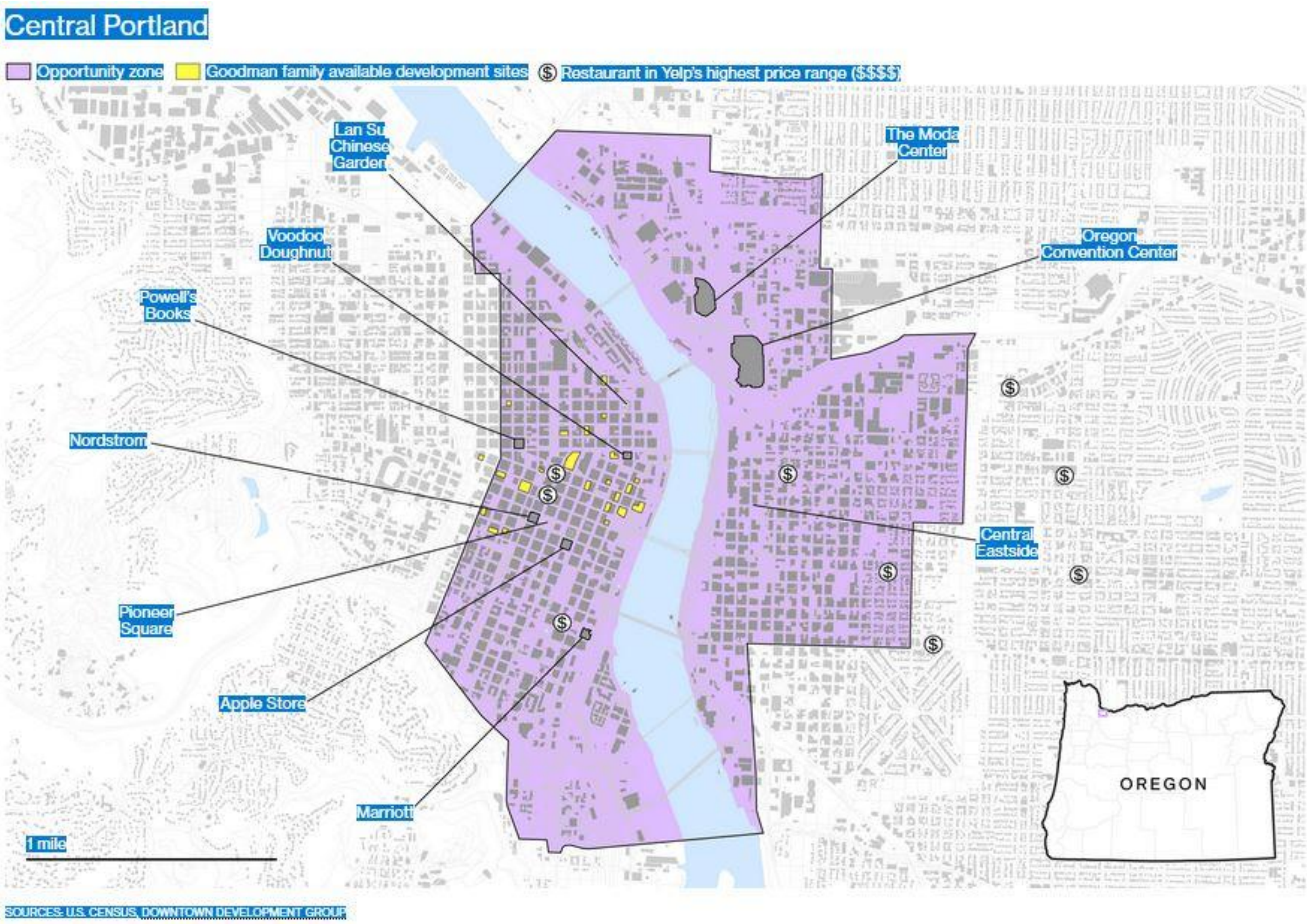
Welcome to Tax Breaklandia

Bloomberg Business Week
By [Noah Buhayar] and [Lauren Leatherby]

▲ A view of Portland's downtown, much of which has been designated as opportunity zones. PHOTOGRAPHER: CLAYTON COTTERELL FOR BLOOMBERG BUSINESSWEEK

On a wet December evening, Mark Goodman steers a black Mercedes SUV into an open-air parking lot, one of dozens of development sites his family owns across downtown Portland, Ore. This one, he says, will be a $206 million tower with ground-floor retail, six floors of offices, and more than 200 luxury apartments. Amenities will include a yoga studio and roof deck. But the centerpiece will be a swimming pool that cantilevers out of the eighth floor. “The one thing I can say absolutely with certainty—it’ll be the finest for-rent product in the city,” Goodman says. It’s also eligible for a U.S. tax break meant to help the poor.

Portland is about to see a flurry of construction because of a provision in the 2017 tax overhaul that led to the creation of more than 8,700 “opportunity zones” across the country—areas that, in theory, have been ignored by investors and need generous tax breaks to catch up. But Oregon did an audacious thing: It selected the entire downtown of its largest city to be eligible for the law’s suite of benefits, as well as neighborhoods such as the Pearl District, where new high-rises loom over old industrial spaces converted into "creative" offices and boutique furniture stores sit near juice bars serving açai bowls. The Central Eastside, an area that Portland's alt weekly crowned the city's "best food neighborhood," is also included.



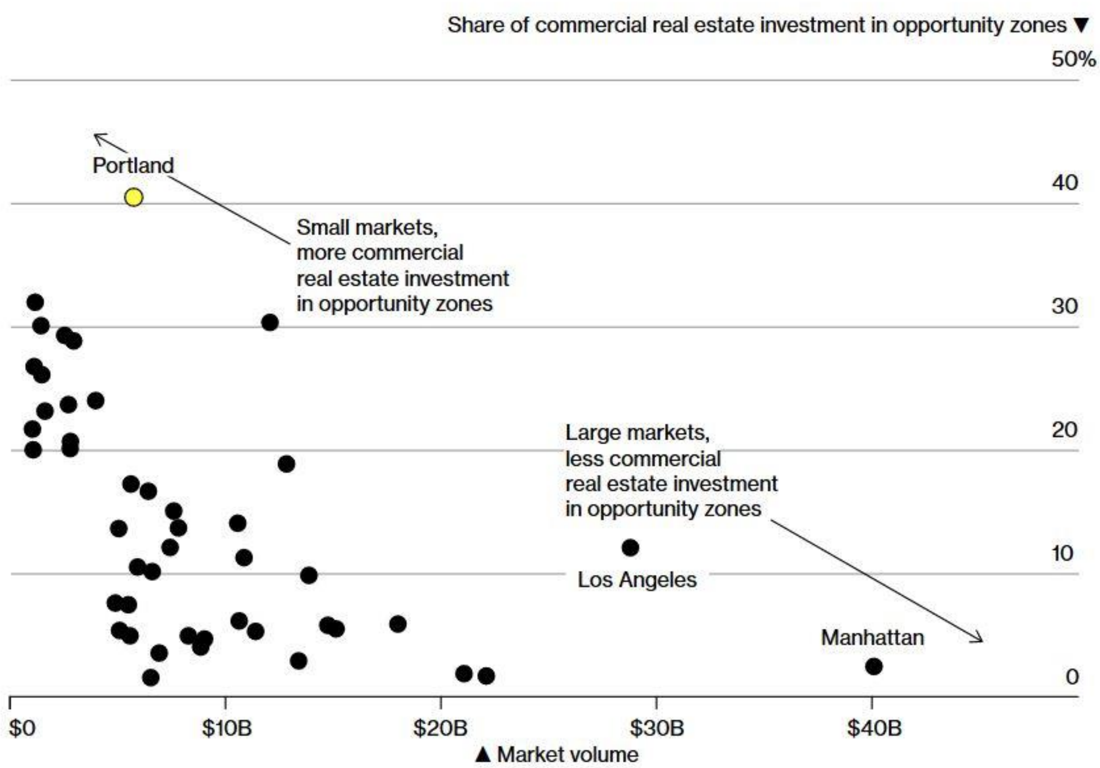
That's turning this city of about 650,000 into a microcosm of what critics see as one of the biggest problems with opportunity zones: Among a nationwide patchwork of struggling areas, there are a small number of thriving communities that may draw an outsize share of investors' cash. In some cases, the law may boost returns on investments that would've happened anyway. Some projects "could get more money than entire states," says Brett Theodos, a senior researcher at the Urban Institute who has studied the policy.

Goodman and his brother Greg are canny investors. But this time they just got lucky. Their grandfather started a parking lot business in Portland in the 1950s that they and their dad expanded over the years to include roughly 200 sites around the area. Portland's famed street-food scene owes much to their decision some years back to turn over a few lots to the carts. In 2013 the family sold the business but kept the land. Their Downtown Development Group now has more than two dozen properties in the city that they hope to build on themselves or with partners.

At first the Goodmans didn't know about the incentives, which allow investors to defer and reduce taxes on capital gains they've already earned if they reinvest the money in the zones. (New investments in these low-income areas are exempt from capital-gains taxes if held for more than a decade.) Once the maps were set, though, the brothers realized their windfall: All but one of their development sites were in areas eligible for the breaks. They'd been thinking about bringing in a financial partner on the luxury tower and decided to market it to investment funds hoping to claim the benefits. "We're getting fantastic interest," says Goodman.

To qualify for inclusion, almost all opportunity zones had to have poverty rates above 20 percent or family incomes that are no more than 80 percent of the area median. A handful—such as swaths of Oakland, Calif., and New York City—are generating buzz because they're already in the path of development. Yet even among these sought-after areas, Portland stands out. More than 40 percent of commercial real estate investment there during the past three years fell within areas now zoned for the tax breaks, a far higher percentage than in any other major U.S. city, according to a recent analysis by Real Capital Analytics Inc.

Zoned for investment



SOURCE: REAL CAPITAL ANALYTICS
THE SHARE OF COMMERCIAL REAL ESTATE INVESTMENT ACTIVITY IN WHAT ARE NOW OPPORTUNITY ZONES IS CALCULATED BETWEEN 2015 AND Q3 2018.

Portland’s zones are so atypical that Barry Sternlicht, the real estate investor and founder of the Starwood hotel chain, used the city as a punchline when he criticized Congress for passing the tax breaks. “That’s not a blighted district,” he scoffed on a recent conference call. “Only in Washington would they say this helps the poor.”

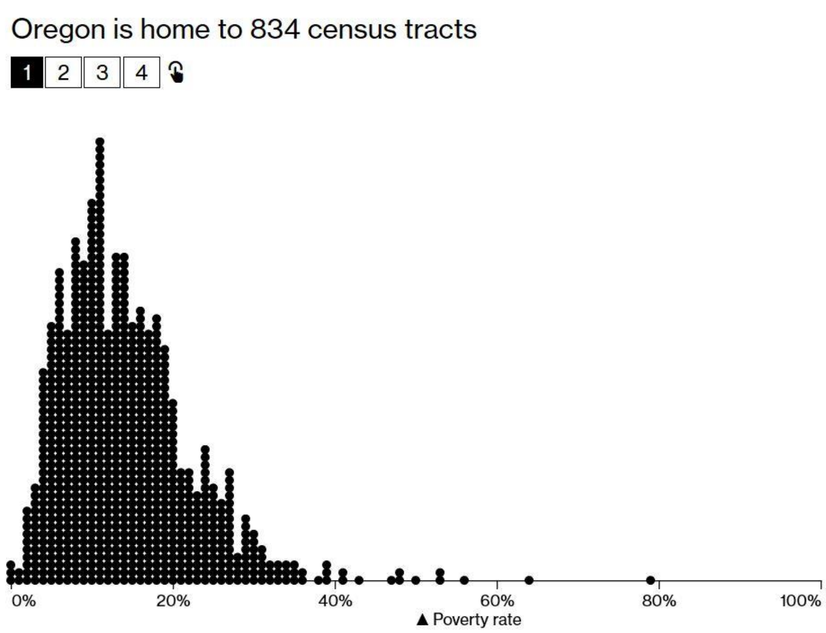
Portland is in many ways a study in contrasts. The city long ago became a magnet for new-economy workers drawn to its indie music and food scenes, as well as a cheaper cost of living than in New York and San Francisco. As the former lumber town grew, real estate developers rushed to sand over its grittier edges for these new arrivals, who’ve pushed up rents by 43 percent since 2010. Nevertheless, the poverty rate remains stubbornly high—a product of the fact that downtown, with its Nordstrom and Apple Store, also includes low-income housing. In neighborhoods such as Old Town Chinatown, it’s not uncommon to see homeless sleeping in tents near a new food hall.

That such areas were picked for the incentives has something to do with the rushed and imperfect process for designating zones. After the tax law passed in the final days of 2017, governors were given 90 days to select the areas they wanted to nominate from a list of low-income census tracts in their states. Officials in Oregon pulled employment data for each eligible zone to figure out where growth was strongest, on the theory that the best predictor of future investment was past economic activity. They also sought input from local leaders, American Indian tribes, housing advocates, businesses, philanthropies, and community organizations.

“We were looking for zones that had some kind of a mix between a real ability to attract investment as well as a real need,” Jason Lewis-Berry, an economic adviser to Oregon Governor Kate Brown, told state legislators in May. Surprisingly, some of the people most likely to benefit from the incentives barely took notice of the process. Early on, officials invited real estate developers to one of their meetings, says Nick Batz, government affairs and policy manager for Business Oregon, the state’s economic development agency. “I don’t think many came,” he says. “If I recall, it was one or two.”

The level of interest shot up when the selections were made. Like the Goodmans, Todd Gooding, the president of Portland developer ScanlanKemperBard, recognized the potential. “I said, ‘Holy crap, we’ve got to put some time and energy into this,’ ” he says. About a dozen blocks on either side of the Willamette River, which bisects the city, would be eligible for the breaks. “That’s probably the best set of options on the entire West Coast,” he says. “Now everybody’s running around like a chicken with their head cut off trying to tie up real estate.”

The central Portland tracts had among the state's highest investment flows, according to the Urban Institute



SOURCES: URBAN INSTITUTE, U.S. CENSUS BUREAU 2016 ACS 5-YEAR ESTIMATES
THE URBAN INSTITUTE DEVELOPED AN INVESTMENT FLOWS SCORE FOR OPPORTUNITY ZONES FROM ONE (LOW) TO 10 (HIGH) BASED ON COMMERCIAL LENDING, MULTI-FAMILY LENDING, SINGLE-FAMILY LENDING AND SMALL BUSINESS LENDING BETWEEN 2011 AND 2015.

Of those, 86 were chosen to be opportunity zones

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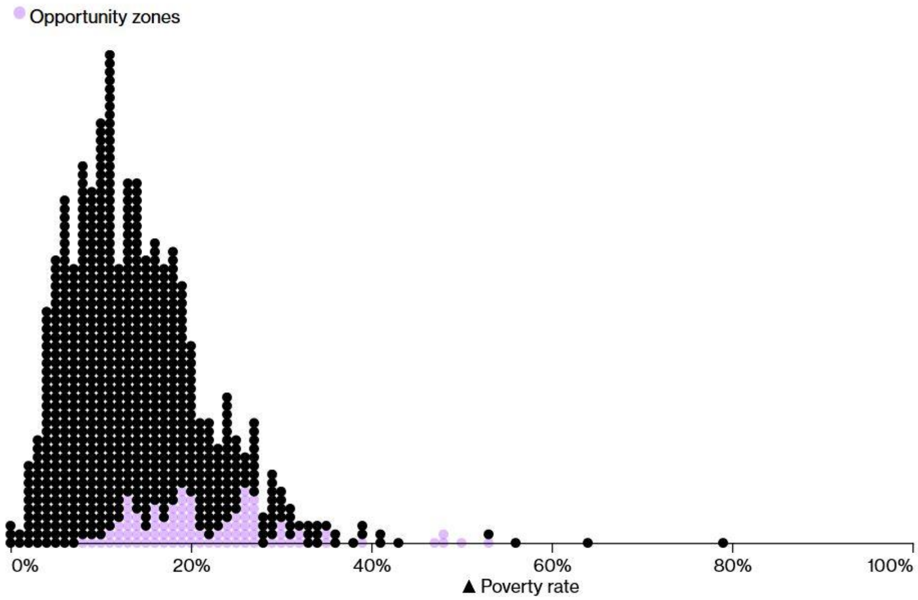

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Seven tracts are in central Portland

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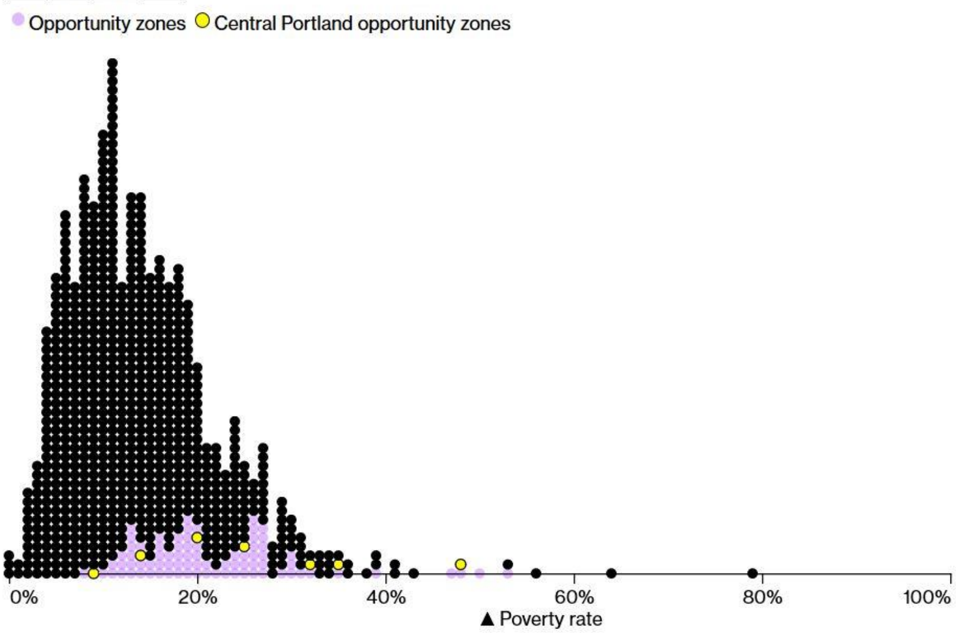

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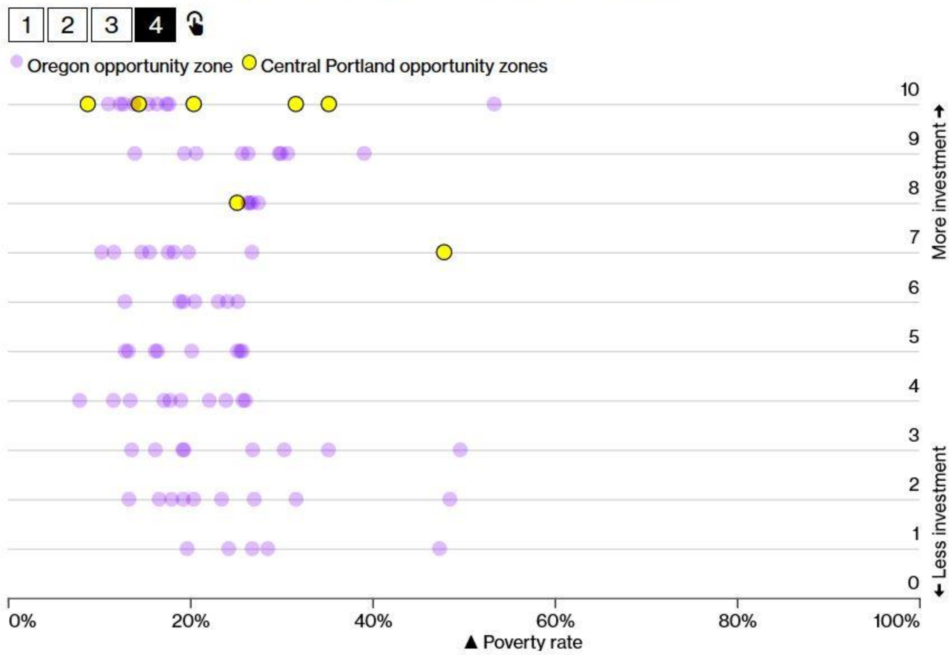

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Graham Taylor, a commercial broker at CBRE Group Inc., says about 50 investors signed confidentiality agreements to look at a property with development potential during the first week he had it listed in December. “Our interest is double what I would have expected a year ago,” he says. The kinds of investors are also different. In the past, private real estate companies would have been the main bidders. Now, he says, big institutions such as banks and insurance companies have raised money to spend in opportunity zones. “It’s really creating a lot of buzz in this market.”

Whether this flurry of activity ultimately benefits low-income residents is uncertain. “Take out your crystal ball,” says Justin Douglas, a policy, research, and compliance manager at Prosper Portland, the city’s economic and urban development agency. “It could have extremely positive results. It could have really negative ones.” Efforts are underway to ensure some of the gains go to the needy. Tad Savinar, a former member of Portland’s design commission, says he’s encouraged city officials to expedite permits for “community-oriented” projects, such as low-income housing and job-training centers.

Portland, like several other U.S. cities, has tried to address climbing rents by forcing developers of larger apartment buildings to include affordable units. But the policy, which went into effect in February 2017, is largely seen to have backfired. A surge of projects was proposed before then to avoid the requirement, and now the pipeline of new developments has slowed to a trickle because there’s a glut of supply and builders say the requirements don’t make sense economically.

Some local developers say opportunity-zone tax breaks could make the math work again. “We’re going to have some affordable housing” because of this, says Vanessa Sturgeon, whose Sturgeon Development Partners is raising money to construct a new tower in one of Portland’s zones. “There is really no fail-safe way to implement a policy like this. But I do see it doing a lot more good than harm.”

The Goodmans’ luxury development won’t be required to have any affordable units, because it was proposed before the city requirement went into effect. But other apartment buildings the family is constructing nearby will. Mark Goodman says he understands the criticism of some of Portland’s opportunity zones, especially the one that includes the Pearl, “our toniest district of all.” But there are other areas in the city that were languishing and could use a boost, he says.

On the bright side, the incentives have spurred interest among investors who want to own properties for the long haul, because the biggest potential tax benefits come for investments held for more than a decade. For a family that sees its legacy in finding a higher and better use for parking lots, that sort of patience is important. “We want a multigenerational community feel here, something our kids can be proud of,” Goodman says. “The opportunity zones codified what we wanted to do all along.”

At the end of the day, the blame for projects that don’t fit the spirit of the law rests with Congress for enacting such a flexible set of incentives, says the Urban Institute’s Theodos. “Don’t hate the player, hate the game.” —Noah Buhayar

Editors: David Scheer and Mira Rojanasakul