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Economic and Fiscal Impacts of California Conformity to Federal Opportunity Zone Tax Provisions

California conformity to federal opportunity zone tax provisions would result in significant economic gains for disadvantaged communities and relatively minor state revenue losses. In this brief we summarize the federal provisions and highlight the key findings of our analysis. We provide more detail on our model, assumptions, and results in the attached appendix.

The federal provisions. The federal Tax Cut and Jobs Act of 2017 established favorable tax treatment for investments made in designated economically depressed communities meeting certain IRS criteria, referred to as opportunity zones (OZs). Under the program, taxpayers may defer taxation on a realized capital gain for up to 7 years by investing it in an OZ. When taxed, the basis of the realized gain is increased by as much as 15 percent. In addition, capital gains on OZ investments held for at least 10 years are permanently excluded from taxpayer income.

Impacts of conformity. The major impacts would be (1) an initial reduction in income tax revenue due to deferral of taxation on capital gains diverted into OZs; (2) increased income tax revenues in subsequent years when deferred taxation occurs; (3) economic and tax-revenue gains due increased investment level; and (4) a future reduction in revenues when certain OZ investments (those that would have occurred absent conformity) are sold after 10 years and the capital gains are excluded from taxation. There are many factors affecting the net economic and revenue impacts of state conformity, such as the amount of OZ investment incentivized by state tax reductions versus the amount of investment that would have taken place without any changes to existing state law.

Specific estimates. Since the full impact of the economic and revenue impacts of a single year of conformity would take over a decade to play out, our estimates include the first-year impact as well as the discounted present value of the related out-year impacts. Given the uncertainty of many factors affecting the outcome, we present a range based on assumptions described in the appendix. Under our principal estimate, conformity would result in a state tax reduction of $51 million, but a net gain in economic output from incentivized investment of $930 million. This suggests that each dollar of state revenue loss would produce $18 of economic gain. Even in the pessimistic alternative, the benefit/cost ratio would be 10:1, while the optimistic alternative would produce a ratio of 66:1.

Impacts of California Conformity: Key Results Under 3 Alternative Scenarios (Dollars in Millions)

	Pessimistic	Principal Estimate	Optimistic
State Revenue	-$73	-$51	-$18
Local Revenue	$11	$12	$15
Economic Increase	$745	$930	$1,200

Multi-Year Impact of California Conformity to Federal Opportunity Zone Tax Provisions

In our previous brief, we presented an analysis of the revenue and economic impacts of California conformity to federal tax provisions related to Opportunity Zones. That brief focused on the present value of all current and future impacts associated with investments made in 2019 – the year in which investors would receive the maximum tax benefits from the federal and state programs. In this brief, we show the estimated present-value impacts for investments made each year through 2026. We also provide a second perspective by showing the cumulative impacts of all conformity-related OZ investments (made in the then-current year and all past years) on each year from 2019 through 2035.

Background – Taxation of OZ Investments

Under the federal OZ program, taxpayers may defer federal taxation on capital gains by investing the proceeds through a qualified opportunity fund (QOF) into an opportunity zone (OZ). Taxation of the gains are then deferred until the taxpayer sells the shares in the QOF, but no later than December 2026. In addition, the basis of capital gains rolled into the QOFs is stepped up by 10 percent if the shares in the QOF are held for 5 years, and by 15 percent if the shares are held 7 years. Capital gains on the investments made through the QOFs and held for at least 10 years are permanently excluded from taxation.

Present Value of Conformity Impacts – 2019 through 2026

Figure 1 shows the net present value of all gains and losses to California due to conformity to federal law for OZ investments made each year from 2019 through 2026. As the figure indicates, the fiscal and economic impacts – positive and negative – decline in 2020 and beyond relative to 2019. The diminished effect partly reflects the reduced number of years that taxation of capital may be deferred under the program – from 7 years for investments made in 2019 down to zero years for investments made in 2026 and thereafter. It also reflects the drop in the maximum amount by which the basis in capital gains rolled into OZ investments can be stepped up – from 15 percent for investments made in 2019 to 10 percent for investments made in 2020 and 2021, and to zero for investments made in 2022 and thereafter. The reduced deferral period and elimination of the step-up in basis for capital gains invested in OZs both diminish the present-value revenue loss associated with investments in 2020 through 2026. At the same time, they also lower the tax incentives to invest in OZs, which reduces the increased economic and revenue activity resulting from investments incentivized by conformity. The remaining incentive for investments made in 2026 and beyond is the permanent exclusion from taxation all capital gains arising from the future sale of OZ investments held at least 10 years.

Figure 1
Fiscal Impact of Conformity: Present Value of Impacts
($ in Millions)

PV of Impacts	Year of OZ Investment							
	2019	2020	2021	2022	2023	2024	2025	2026
State Taxes	-$51	-$46	-$45	-$34	-$32	-$30	-$28	-$26
Local Taxes	$12	$10	$10	$8	$7	$7	$7	$7
Economic Output	$930	$790	$750	$610	$560	$540	$510	$480

Cumulative Impacts – 2019 through 2035

Figure 2 (next page) provides a different perspective on the revenue impacts of conformity. Instead of showing the present value of current and future year impacts of conformity for OZ investments made in a particular year, Figure 2 shows the cumulative impact of all current and past OZ investments on net revenues for each year shown. In 2019, for example, conformity would result in an annual revenue reduction of $85 million in state funds, partly offset by a local revenue increase of $7 million. As the years move forward, the net reduction in state revenues declines as the positive impacts of new investment and deferred taxation of rolled-in capital gains begins to take effect. In 2026, the state would experience a major revenue gain due to deferred taxation of all capital gains rolled into OZ investments. After 2026, the state would experience modest revenue gains until 2029 when capital gains on assets sold after being held for 10 years start becoming excluded from taxation. Local revenue increases remain relatively constant through 2026, reflecting offsetting impacts of (1) less newly incentive investment as tax savings associated with tax-deferrals diminish, and (2) cumulative gains associated with ongoing economic activity flowing past OZ investments grows.

Figure 2
Fiscal Impact of Conformity: Cumulative Annual Impact on Revenues of All OZ Investments Made in Current and Past Years
($ in Millions)

Year	State Taxes	Local Taxes	Combined Taxes
2019	-$85	$7	-$77
2020	-$78	$7	-$71
2021	-$75	$7	-$69
2022	-$65	$6	-$58
2023	-$60	$7	-$54
2024	-$48	$7	-$42
2025	-$42	$7	-$35
2026	$482	$7	$489
2027	$12	$7	$19
2028	$12	$7	$20
2029	-$12	$7	-$4
2030	-$35	$8	-$27
2031	-$58	$8	-$50
2032	-$55	$8	-$46
2033	-$46	$8	-$38
2034	-$44	$9	-$36
2035	-$44	$9	-$35

Appendix: Detailed Analysis of California Conformity to Federal Opportunity Zone Tax Law

The federal Tax Cut and Jobs Act of 2017 established favorable tax treatment for investments made in designated economically depressed communities meeting certain IRS criteria. California has designated 879 of these "opportunity zones" within the state's boundaries. Under the program, taxpayers may defer federal taxation on capital gains by investing the proceeds through a qualified opportunity fund (QOF) into an opportunity zone (OZ). Taxation of the gains are then deferred until the taxpayer sells the shares in the QOF, but no later than December 2026. In addition, the basis of capital gains rolled into the QOFs is stepped up by 10 percent if the shares in the QOF are held for 5 years, and by 15 percent if the shares are held 7 years. Capital gains on the investments made through the QOFs and held for at least 10 years are permanently excluded from taxpayer income.

Normally, we would expect favorable federal tax treatment alone to have a strong positive impact on the level of QOF investments. However, California's extraordinarily high state tax rates on capital gains – ranging up to 13.3 percent for individual investors, or nearly two-thirds of the federal rate – may present a barrier to investors that would otherwise be incentivized by the federal program.

Estimation Methodology

There are many factors affecting the costs and benefits of state conformity to the federal OZ tax provisions. In order to capture these impacts, we developed a financial model that traces the potential impacts of California conformity on ten different categories of investors.

Categories of investors. For purposes of our calculations, we first divided the investors into those that are California residents (or in the case of corporations, have nexus or taxable presence in this state), and those that are out-of-state investors. For each of these groups, we further divided investors into individuals and corporations. Key reasons for these divisions are differences in tax rates and related income sourcing rules that are applied to each type of investor.

We further divided each of these groups into two sub-groups: (1) those that would have undertaken the investment without state conformity (which we refer to as "windfall" investors); and (2) those that are incentivized by state conformity. Lastly, we divided the in-state incentivized group into investors those that were prompted by conformity to shift capital gains already realized from otherwise taxable investments into opportunity funds, and those that are newly prompted by the state tax benefits to sell appreciated capital assets and invest the proceeds into the QOFs. We allocated out-of-state investors in a similar manner.

Dollar allocations of investments into various groups were made by starting with national estimates of the fiscal impacts of the federal OZ tax-related provisions developed by the Joint Committee on Taxation and the U.S. Treasury, from which we inferred national levels of OZ investments. We then allocated these estimates to California based on the state's share of the U.S. economy and/or its share of U.S. capital gains realizations (depending on the scenario). We then estimated the amount of incentivized investment based on (1) the impacts on after-tax return on OZ investments, and (2) the impact of changes in after-tax returns on investment levels, using a simple investment elasticity equation.

After these initial allocations of investments into ten categories, we then then traced through, for each category, the revenue gains and losses to state and local governments associated with state conformity to federal OZ law. The main effects are:

- The delay in taxation (and present-value loss) of taxation of gains rolled into OZ investments;

- The reduction in the deferred taxes on rolled-in capital gains due to the 10 percent (for investments held for 5 or 6 years) or 15 percent (for investments held 7 years) step-up in basis on these invested gains;

- The exclusion from taxation of future capital gains on OZ investments that are held for 10 years or more and then sold; and

- The increase in state and local tax revenues associated with any net increase in investment levels in California due to conformity.

Because the costs and revenues associated with state conformity would play out over more than a decade, we express our results in terms of the net present value of all current and future gains and losses resulting from a single year's worth of investments. For purposes of these calculations, we used a discount rate of 4 percent.

These estimates are for investments taking place in 2019, which would receive the maximum benefit of the federal provisions. This includes an up-to-7 years deferral on capital gains and a 15 percent step-up in basis on capital gain realizations rolled into opportunity funds. The maximum basis step-up will drop to 10 percent in 2020 and 2021. It will be entirely eliminated for investments made in 2022 and beyond. And since taxation on deferred realized gains takes place no later than December 2026, the maximum deferral period becomes shorter and shorter in each subsequent year. Because of the reduced taxpayer benefit occurring in years after 2019, we expect both the costs and incentives resulting from conformity to diminish some in future years unless the deferral provisions are extended. (The exclusion of capital gains from OZ investments held more than 10 years would remain in effect.)

Key Inputs to the Model

The model is based on about two-dozen inputs regarding factors such as federal and state effective tax rates on capital gains, average appreciation rates for OZ investments, and the discount rate applied to future gains and losses. While bottom-line results are significantly impacted by all of these factors, we found the following to have the greatest impact on the estimated net cost of conformity:

- The total amount of OZ investments that would be made in the absence of state conformity, which we refer to as "windfall" investments, since state conformity will result in a windfall tax benefit for activities that would have occurred anyway.

- The amount of additional investments that would be *incentivized* by state conformity.

- The percentage of these incentivized investments that come from new realizations (hence resulting in new economic activity) versus the percentage that comes from the redirection of proceeds from capital gains realizations that had been targeted for otherwise taxable investments in California.

- The proportion of investments made by individual taxpayers through partnerships, versus by corporations.

Fiscal Impacts Under Three Alternatives

Because the OZ program is new, there are uncertainties regarding each of four key factors listed above. For this reason, we developed three scenarios - a principal estimate and two alternatives - that we believe encompass a reasonable range of likely outcomes. The basic characteristics of each alternative are summarized in Appendix Table 1. The specific assumptions for each scenario are described in more detail below. The detailed impacts under our principal estimate and the alternatives are shown in Appendix Tables 2, 3 and 4.

Appendix Table 1
Characteristics of Principal and Alternative Estimates

Factor	Estimate		
	Principal	**Alternative A**	**Alternative B**
Windfall OZ related investment amount	Medium	Low	High
Incentivized investment amount	Medium	High	Low
Ratio of new vs. displaced investment	Medium	High	Low
Investments made through partnerships vs. corporations	40%-60%	25%-75%	50%-50%

Principal Estimate

Key Assumptions. Our principal estimate is based on "middle-ground" assumptions about the key factors discussed above. Our estimate of the windfall investment amount starts with the estimates of the nationwide revenue losses associated with the federal OZ provisions made by the Joint Committee on Taxation (JCT) and the U.S. Treasury in 2018. Both of these entities are assuming a federal reduction of about $2 billion in 2019, which is consistent with OZ investment levels of about $8.5 billion nationwide. We reduced these estimates by about 20 percent to reflect delays in the issuance of final guidance by the I.R.S. relating to the federal policy. (These final regulations had not yet been issued at the time of our analysis).

We then calculated the share of the national investments attributable to California investors using an apportionment factor of 15.5 percent for partnership returns - which is the average of California's share of the U.S. economy (13 percent) and its share of U.S. capital gains realizations each year (18 percent) – and 8.5 percent for corporations (based on average sales apportionment factor for apportioning companies). We then estimated the amount of additional gains incentivized by California conformity to federal law by (1) calculating the effect that conformity would have on the after-tax return on a typical OZ investment; and then (2) applying a ROI elasticity to this change to arrive at increased investment levels. For our principal estimate, we used an elasticity of 1.0, which is consistent with a moderate investment response.

Other key assumptions used in our principal estimate are that (1) 75 percent of newly incentivized investment in OZs would be supported by additional capital gains realizations, while the remaining 25 percent would be from the redirection of capital gains proceeds from taxable investments; and (2) 40 percent of investments would be made through partnerships and the other 60 percent would be made by corporations. The partnership-corporation split is roughly the average of the assumptions used by the JCT (which assumed 75 percent of OZ investments will be made by corporations), and Treasury, which assumed 45 percent would be made through corporations.

Results. Under our principal estimate, conformity would result in a net reduction in state and local revenues of $38 million. Again, this is the net present value of all gains and losses flowing from a single year of OZ investments. The net total consists of a $51 million loss in state revenues, partly offset by an increase of $12 million in local revenues (detail may not add to total due to rounding). In present value terms, the cumulative amount of new economic activity associated a single year's worth of OZ investments would be $930 million. This suggests that each dollar in state costs would yield about $18 in additional economic output. This estimate takes into account both the initial construction-related activity association with OZ investments as well as the present value of ongoing economic activity associated with the project.

Alternative A – More Optimistic Assumptions

Key Assumptions. Compared to our principal estimate, this alternative assumes a higher amount of incentivized investment, a relatively smaller amount of windfall-related losses, less redirection of existing taxable investments, and a higher proportion of investments through corporations.

For this alternative, we assume the national level of capital gains rolled into OZ investments to be $7.2 billion – roughly 15 percent less than the baseline estimate. It also assumes that, on the partnership side, California's share of national OZ investment under the federal OZ provisions is consistent with its 13 percent share of the national economy, as opposed to its higher 15.5 percent share of capital gains realizations assumed in our principal estimate.

Under this alternative, we assume an investment elasticity (with respect to changes in after-tax ROI) of 1.3, thus assuming that investments are more responsive to changes in state tax rates than assumed in the principal estimate. We also assume that relatively more (85 percent) of the incentivized investment is from newly realized capital gains as opposed to the redirection of realized gains from taxable investments. Further, we assume that relatively more (75 percent) of the investment is coming from corporations compared to the principal estimate. The latter assumption – which is consistent with the JCT estimate - is significant because corporations are subject to lower maximum tax rates than individuals under California law. Hence the loss in taxes associated with a capital gain deferral or exclusion is correspondingly less.

Results. Under this more optimistic, though achievable, set of assumptions, conformity to federal law would result in a small net reduction in combined state and local revenues of $3 million. This consists of a $18 million reduction in state revenues and a $15 million increase in local revenues. Under this scenario, the revenue increase resulting from newly incentivized capital gains realizations and associated investment activity nearly matches "windfall" related tax losses for investments that would have occurred in absence of state conformity. Finally, the amount of newly incentivized economic activity under this alternative would be $1.2 billion, representing a $66 increase in economic activity for each dollar of state revenue reduction.

Alternative B – More Pessimistic Assumptions

Key Assumptions. This alternative is characterized by relatively high levels of windfall-related tax losses, low amounts of incentivized investment, a relatively higher share of OZ investments coming from a redirection of existing taxable investments, and an even split between partnerships and corporate investors. The cumulative effect of these individual assumptions is, if not a "worst case scenario," definitely an extremely conservative one.

Specifically, this alternative is based on the assumption that OZ-related investments (before California conformity) exceed $9.8 billion, and that, on the partnership side, California residents account for 18 percent of the national total. The combination of these factors leads to $115 million in tax losses related to investments that would have taken place in absence of state conformity. We also assume a relatively low investment elasticity of 0.7 percent with respect to changes in the after-tax rate of return on OZ investments, implying that investors would be relatively unresponsive to reductions in California state tax rates. We further assume that fully 35 percent of newly incentivized OZ investments are redirected from taxable investments and only 65 percent comes from additional capital gains realizations. Lastly, we assume that 50 percent of investments are made through partnerships (as compared to 40 percent in the principal forecast), which are taxed at higher rates than corporations.

Results. Under this alternative, state conformity would result in a net reduction in state and local revenues of about $62 million, as the tax losses associated with large amount of "windfall" investments outweigh increases associated with the relatively limited amount of newly incentivized investments. State revenues would decline by about $73 million, due to large windfall-related losses in income taxes. This would be partly offset by an increase of $11 million in local revenues, reflecting a relatively modest amount of new economic activity. Even under this pessimistic alternative, the amount of newly incentivized economic activity would be $745 million, representing a $10 increase for each dollar in state revenue loss.

Detailed Breakout of Impacts

More detailed impacts associated with the three alternatives are displayed in Appendix Table 2 through Appendix Table 4. For simplicity, the tables combine some of the categories that we modeled (e.g. partnership and corporate investors), so that all investors are displayed in four main groups. These consist of in-state and out-of-state investors, each further divided into windfall and incentivized investors. In the following paragraphs, we trace through the impacts for our principal estimate, shown in Appendix Table 2.

Capital Gains Realizations

The first row of Appendix Table 2 shows that capital gains realizations and OZ investments potentially having tax implications in California would total about $2.6 billion. This is considerably more than the amount of OZ-related investments actually made in California. The total includes <u>all</u> OZ capital gains realized by California investors – both those investing in California projects and out-of-state projects – as well as the value of out-of-state capital gains invested in California OZs. Of the $2.5 billion total, $265 million is from California investors that are incentivized by conformity, $1.0 billion is from California investors that would have realized gains and invested the funds in any event, $290 million is from out-of-state investors incentivized by conformity, and $883 billion is from out-of-state investors that would have invested in California absent state conformity.

Revenue Impacts

Appendix Table 2 further shows that conformity to federal law would have three types of impacts on California revenues. These impacts vary among the four types of investors:

Impact # 1 - deferral of taxation on capital gains invested in QOFs. Conformity would allow California state taxpayers to defer taxation on gains used to invest in a QOF. For simplicity, we assume that the investment occurs in the same year that the gains are realized, though U.S. Treasury regulations permits up to 180 days between the recognition of the gain and investment in a QOF. The net impact of these deferrals varies for each group of investors.

For in-state taxpayers incentivized to invest in QOFs by state conformity, there would be a significant revenue gain, which we estimate to be $8 million in present value terms. This increase occurs because the majority of taxpayers in this group would not otherwise realize a taxable capital gain in the ten-year window of our projections. By incentivizing these taxpayers to realize gains and invest them in OZs, conformity will result in additional income taxes paid to the state, either when the QOF share is sold by the investor, or by December 2026, whichever is earlier.

For the "windfall" group of California taxpayers that would have invested in QOFs anyway, the impact would be a revenue loss to the state of $29 million in present value terms. The net loss is due to the effects of the deferral on the present discounted value of capital gains-related tax payments, as well as the reduced tax liabilities resulting from the step-up in basis for QOF assets held for at least five years.

We show no deferral-related impacts from out-of-state taxpayers, since capital gains rolled into the QOFs are generally derived from the sale of intangible assets (such as shares in a mutual fund or partnership), and thus are subject to taxation in the taxpayer's home state of residence or domicile. (We treat apportioning corporations with taxable nexus in California as in-state investors).

Impact # 2 - exclusion of capital gains on QOF investments held at least 10 years. We estimate that this provision will result in a net loss of $51 million in present value terms. The loss is attributable to "windfall" investors that would have made the investments in California absent conformity, and hence would have paid capital gains taxes upon sale of OZ assets held for at least 10 years.

Impact # 3 - taxes on increased economic activity associated with incentivized OZ investments. This would produce a net increase in state and local taxes of $34 million in present value terms. This consists of the first-year increase associated with taxes levied on income and sales generated by new investment spending in California OZs. It also includes the present discounted value of taxes levied on the ongoing stream of income, sales, and employment generated by commercial activity flowing from the investment in years 2 through 10.

Combined total. The combined total from these three impacts is a reduction of $38 million, consisting of a $51 million reduction in state taxes and a partly offsetting gain of $12 million increase in local taxes on expanded economic activity in opportunity zone communities.

Appendix Table 2
Revenue Impact of California Conformity to Federal Opportunity Zone Provisions
Principal Estimate
(Millions of Dollars)

Impacts	California Investors		Out of State Investors		Total
	Incentivized by California Conformity	Windfall	Incentivized by California Conformity	Windfall	
Estimated QOF Related Capital Gains	$265	$1,020	$290	$883	$2,458
Tax Impacts					
1. Deferral of capital gains					
Loss in Year 1	-$6	-$91	$0	$0	-$98
PV of gains in Years 2 through 7	$14	$62	$0	$0	$76
PV of Net Gain/Loss	$8	-$29	$0	$0	-$21
2. PV of exclusion on QOF investments held > 10 years	-$2	-$27	$0	-$22	-$50
3. PV of taxes on increased economic activity					
State taxes	$14	$0	$7	$0	$21
Local Taxes	$8	$0	$4	$0	$12
Total	$23	$0	$11	$0	$34
Net Impact					
State Taxes	$21	-$56	$7	-$22	-$50
Local Taxes	$8	$0	$4	$0	$12
Combined	$29	-$56	$11	-$22	-$38

Appendix Table 3
Revenue Impact of California Conformity to Federal Opportunity Zone Provisions
Alternative A – More Optimistic Assumptions
(Millions of Dollars)

Impacts	California Investors		Out of State Investors		Total
	Incentivized by California Conformity	Windfall	Incentivized by California Conformity	Windfall	
Estimated QOF Related Capital Gains	$308	$747	$389	$771	$2,216
Tax Impacts					
1. Deferral of capital gains					
Loss in Year 1	-$4	-$60	$0	$0	-$64
PV of gains in Years 2 through 7	$15	$41	$0	$0	$56
PV of Net Gain/Loss	$11	-$19	$0	$0	-$8
2. PV of exclusion on QOF investments held > 10 years	-$1	-$18	$0	-$17	-$36
3. PV of taxes on increased economic activity					
State taxes	$17	$0	$9	$0	$26
Local Taxes	$10	$0	$5	$0	$15
Total	$26	$0	$15	$0	$41
Net Impact					
State Taxes	$27	-$37	$9	-$17	-$18
Local Taxes	$10	$0	$5	$0	$15
Combined	$37	-$37	$15	-$17	-$3

Appendix Table 4
Revenue Impact of California Conformity to Federal Opportunity Zone Provisions
Alternative B – More Pessimistic Assumptions
(Millions of Dollars)

Impacts	California Investors		Out of State Investors		Total
	Incentivized by California Conformity	Windfall	Incentivized by California Conformity	Windfall	
Estimated QOF Related Capital Gains	$250	$1,211	$214	$880	$2,555
Tax Impacts					
1. Deferral of capital gains					
Loss in Year 1	-$9	-$115	$0	$0	-$124
PV of gains in Years 2 through 7	$13	$78	$0	$0	$92
PV of Net Gain/Loss	$5	-$37	$0	$0	-$32
2. PV of exclusion on QOF investments held > 10 years	-$3	-$34	$0	-$22	-$59
3. PV of taxes on increased economic activity					
State taxes	$14	$0	$5	$0	$19
Local Taxes	$8	$0	$3	$0	$11
Total	$21	$0	$8	$0	$29
Net Impact					
State Taxes	$16	-$71	$5	-$22	-$72
Local Taxes	$8	$0	$3	$0	$11
Combined	$23	-$71	$8	-$22	-$62