



Memorandum

TO: COMMUNITY & ECONOMIC
DEVELOPMENT COMMITTEE

FROM: Chris Burton

SUBJECT: 2019 UPDATE ON SAN JOSÉ
OPPORTUNITY ZONES

DATE: February 11, 2019

Approved

Date

2/13/19

RECOMMENDATION

Accept staff's report updating the Committee on the Federal Opportunity Zones program and its applicability in San José.

BACKGROUND

The Opportunity Zone federal tax incentive – included in the 2017 Tax Cuts and Jobs Act – is designed to facilitate increased investment in low-income communities across the country. In return for making certain long-term investments in these Zones, investors may realize preferential federal tax treatment.

On March 22, 2018, following a public comment period, the State of California forwarded its recommendation of 879 eligible Census tracts to the U.S. Treasury for certification as Opportunity Zones. On June 20, Treasury published the final list of approved census tracts, totaling 8,700, in all 50 states plus Puerto Rico.

San José has the largest number of designated Opportunity Zones in the Silicon Valley region. Per the tax law's requirements, the City's 11 Zones are census tracts where household income or poverty rates met certain thresholds, and which also showed promise for business expansion or development. San Jose's zones exhibit geographical, economic and demographic diversity, with areas including urban neighborhoods, light and heavy industrial clusters, commercial pockets, suburban office parks and small-business corridors.

While the incentive is still being implemented, it is generating significant interest nationally as well as in the Bay Area. Staff last provided an update to Council in an August 16, 2018 information memo. That memo explained the Zone selection process, the capital gains tax

benefit, San José's Zone-by-Zone breakdown, and potential benefits for the City. (The memo with a map of San Jose's zones are attached as Appendix A.) Since then, the IRS provided a first tranche of technical guidance on implementation, but key questions await further guidance releases. In addition, staff has been monitoring and researching local market interest, state policy responses, stakeholder conversations and concerns, and practical applications. The purpose of this memo is to update the Committee on available information about Opportunity Zones, provide an update on implementation and staff's work, and a look ahead at future activities as the incentive rolls out.

ANALYSIS

The Opportunity Zone incentive is a potentially important economic development tool that could generate new growth and business expansion in these geographies. Experts estimate up to \$6 trillion exists in unrealized capital gains, and the idea behind Opportunity Zones is to encourage investors to roll over some of that capital into areas that need investment and economic development. To that end, "passive" investments (such as buying an existing office or apartment building and making minor renovations) do not qualify under the incentive. Rather, qualified investments must significantly improve or redevelop property, or a business must relocate to, or significantly expand in a Zone to be eligible for investment through an Opportunity Fund.

While the tax law does not delineate a formal role for cities, City staff has been working to prepare for Opportunity Zone investment since Congress passed the legislation. Staff is also taking a proactive role in guiding investment toward potential projects that align with city priorities. These activities include:

- Hosting a February conference at City Hall attended by more than 100 investors, community development experts, stakeholders, philanthropies, property owners and brokers to explore and promote investment in San José's Opportunity Zones.
- Producing a draft "prospectus" to inform investors about San José's Zones, existing social and cultural institutions, and economic development priorities (Appendix B).
- Attending a range of convenings, forums, webinars and workshops on Opportunity Zones including those hosted by Accelerator for America, the Greenlining Institute, and the Federal Reserve of San Francisco.
- Communicating with various audiences such as the San José Downtown Association, brokerage houses, law firms, and various business and community groups.
- Monitoring federal guidance and state legislation to better understand emerging rules.
- Exploring San José Opportunity Zones for potential catalytic investment opportunities that could achieve city goals around job growth, housing production and equitable job opportunities.

The following provides a general update on potential investments in San José's Zones.

Real estate development

Much of the interest in Opportunity Zones has been around real estate development, because new, ground-up real estate projects appear to fit nicely with the incentive's framework and requirement to "improve" property. In San José, staff has witnessed a flurry of interest from investors or developers looking for potential deals in Opportunity Zones, especially in Downtown. Because the incentive has strict deadlines for the deployment of capital, investors are looking for projects closest to being "shovel ready" and are unlikely to enter into deals for projects facing an uncertain or lengthy entitlement process. Interest from new sources of capital could be welcome news in San José, where projects have struggled to attain financing in recent quarters.

Experts are of mixed opinions on just how much Opportunity Zones may help affordable housing developments, but this is also an area of interest. Many affordable housing experts do not believe the financial incentive's structure lines up well enough with affordable housing deals to attract direct investments. For one thing, the return on an affordable project is likely not high enough to attract investment that could otherwise go into a market-rate project. This may be further clarified when the second tranche of IRS guidance is released later this year. On the other hand, if Opportunity Zones facilitate new market-rate housing that wouldn't otherwise occur, cities with inclusionary housing requirements will generate additional below-market units or impact fees to support new affordable homes at some later date. On a positive note, staff has seen interest from developers contemplating mixed-income "workforce housing" projects using Opportunity Fund capital.

Operating Business Investment

Opportunity Funds, which are the vehicles that invest in Opportunity Zones, are not limited to real estate. They may also invest in operating businesses locating in these Zones, as well as existing businesses in Zones (if those existing businesses significantly expand). This could benefit such businesses by providing another source of growth capital through equity investments. So far, IRS guidance has not clarified several outstanding issues, dampening the interest in this application. However, staff is keenly interested because much of the San José Zones' land area is comprised of existing industrial and commercial buildings that could support additional job growth.

Impact Investor Attraction

So-called impact investors are investors who aim to "do good while doing well," or make a profit while investing in projects that also benefit the community or environment. Investment examples could include affordable housing, renewable energy, small-businesses, incubators, catalytic projects (like commercial kitchens), corridor revitalization, and so on. The tax benefits offered by Opportunity Zones, as well as the long-term focus, has generated interest among impact investors nationally. San José is well positioned for these types of investments, but success will require identifying and promoting potential opportunities as well as connecting with investors interested in these types of deals.

Tenant Site Selection

“Site selection” describes the process by which a company analyzes a potential location for relocation or expansion. In light of the business-investment aspect of the incentive, Opportunity Zones could attract additional interest from commercial/industrial tenants. At a recent city-sponsored workshop on Opportunity Zones, Michael Novogradac, a CPA and industry expert, said, “Every business needs to ask itself, Do I need to be in an Opportunity Zone?” More study (and federal guidance) is needed to fully understand the potential benefits and qualifications, but this aspect holds promise for continued momentum in Downtown, North San José, the Berryessa BART-area and the Monterey Corridor Zones.

Infrastructure and Public Land

Theoretically, Opportunity Funds may invest in infrastructure projects in the context of a public/private partnership, though there are many questions about how deals would need to be structured to qualify. Even so, it is worth noting that San José’s Zones include two future BART stations, a stretch of the BART extension’s underground tunnel, and Mineta San José International Airport. Also, the Zones include the City’s Central Service Yard, Santa Clara County’s Fairgrounds parking lot, and VTA’s Chaboya bus yard. Clean-energy projects, such as solar and wind infrastructure, are also potential investments for Opportunity Funds.

Regulatory Update

While the Tax Cuts & Jobs Act detailed the law’s overall framework, the marketplace has been awaiting proposed regulations and additional guidance from the Internal Revenue Service. This guidance is expected to be released in several waves. The first release occurred in October 2018 and clarified key issues, such as timelines and qualifications for deals. Still, key questions remain. The recent government shutdown delayed the next release of guidance, but it is expected in the weeks ahead, though the potential for another government shutdown could delay things further.

There is also movement at the state level. Certain states’ tax laws “conform” to the federal law; in these states, qualified Opportunity Zone investments are also exempt from *state-level* capital gains tax. California is one of several states that do not conform to the federal tax law, potentially making California investments less attractive to Opportunity Funds. Gov. Gavin Newsom’s 2019-2020 budget proposal includes language that would partially conform state tax law in the case of investments in green technology or affordable housing, but so far there are few details. More action is possible: The Governor’s office said it is “exploring layering additional programs on Opportunity Zones and EIFDs (Enhanced Infrastructure Financing Districts) to increase the production of affordable and moderate-income housing.”

Equitable Development and Displacement

San José’s General Plan includes capacity for 400,000 new residents and 382,000 new jobs citywide by 2040. Several of San José’s Opportunity Zones include general plan designations or in-place zoning that facilitate redevelopment, intensification and growth. They also include existing or future transit infrastructure, which are expected to draw additional development interest nearby as these transit nodes mature.

It's possible the Opportunity Zone designations could accelerate growth within the Zones, particularly downtown. Depending on the underlying general plan designations, this could lead to the demolition of below-market units at a faster rate than rent-stabilized units can be created, or than income-restricted affordable units could be built. In this context, existing tenant protections (such as just-cause eviction and Ellis Act requirements), plus the City's inclusionary housing framework, are relevant. It's also important to note that several mobile home parks are located in the Zones. The Department of Planning, Building and Code Enforcement and the Department of Housing have been working for several years on changes to the City's mobile home park ordinance to offer greater protections to tenants across the city.

The issue of rising costs and potential displacement is a regional concern. The City is working to develop an anti-displacement strategy for both small-business and residential tenants. The residential anti-displacement work will identify the neighborhoods that are experiencing displacement, and evaluate tools that balance housing production, housing preservation and tenant protection in areas in the path of growth.

Another aspect of the city's equitable economic goals is to focus on job opportunities for residents. In this respect San Jose's Zones are a potential benefit because they include wide swaths that are primarily light or heavy industrial, and the strategy for these Zones is to encourage additional job growth that supports middle-skilled workers through manufacturing or other industries.

Next Steps

Staff is working on several fronts to best position the city for investment that aligns with City priorities outlined in the General Plan. These include:

- Refining a San José "investment prospectus" (attached) that debuted at the Feb. 4 investor conference that outlines San José's growth potential and community priorities
- Building on the success of that conference with additional convenings around specific topics such as equitable development, clean-tech, industrial investment, small business, and so on
- Continuing to meet with community stakeholders to understand needs, concerns and opportunities
- Scheduling Zone walks with community stakeholders and investors to gain granular insight into each Zone's challenges and potential
- Exploring applications for public infrastructure (BART) and city assets (such as the airport)
- Building out an Opportunity Zone website with informational material as well as video from the Feb. 4 conference and resources relevant to community and economic development
- Monitoring and collaborating with local cities on policy related to Opportunity Zones implementation
- Participating in the California Opportunity Zone Partnership, a consortium of small, medium and large California cities, to share strategies and receive technical assistance

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- Track and categorize inquiries related to Opportunity Zone investment to gain insight into the marketplace's response to the Zones
- Work closely with staff leading the equitable growth plan to coordinate on issues of gentrification and residential/commercial displacement

/s/

CHRIS BURTON

Deputy Director

Office of Economic Development

For questions, please contact Nathan Donato-Weinstein, Business Development Officer, at (408) 535-8178.

Attachments

Appendix A – Information Memorandum Re: Update on Opportunity Zones in San Jose dated August 16, 2018

Appendix B – San Jose Opportunity Zones Guidebook

