OPPORTUNITY ZONES AND COST SEGREGATION

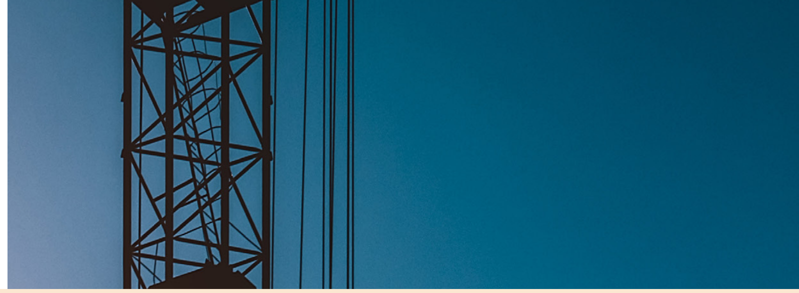
Guest Contributor: Artur Babaian

Opportunity Zones are garnering increased interest across the country. Created by the Tax Cuts and Jobs Act (TCJA) in December 2017, taxpayers who meet the requirements for investing in an Opportunity Zone can potentially defer taxable gain on their current year gain and eliminate any gain on the new Opportunity Zone investment.

Deferring gain into an Opportunity Zone investment differs from a 1031 exchange deferral, which is familiar to most real estate investors. The 1031 exchange is limited to like-kind real estate and requires the entire sales proceeds to be reinvested into the like-kind replacement property. Any sales proceeds not reinvested create taxable gain. Alternatively, capital gain from the sale of any capital asset can be deferred by investing the amount of the gain into an Opportunity Zone investment. Sales proceeds equal to the basis in the capital asset sold can be retained by the taxpayer tax-free.

INSIGHT:
Capital gains are deferred if a 1031 exchange is completed successfully. The basis in the replacement property is reduced by the gain deferred, reducing future depreciation deductions. Any gain realized in the new property, in addition to the gain deferred from the initial property, is taxable in the year the new property is sold.

In a Qualified Opportunity Fund, there are three tax incentives for reinvesting capital gains which are significantly different than the 1031 exchange incentives:



1. Recognition of capital gains are deferred until the Qualified Opportunity Fund is sold or exchanged or December 31, 2026, whichever occurs earliest.

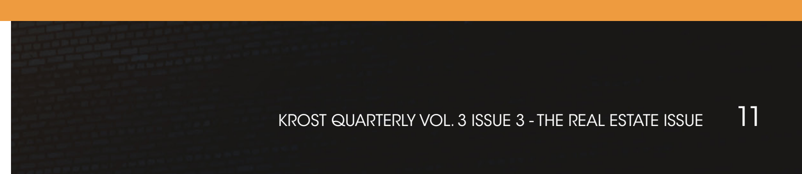
2. If the Qualified Opportunity Fund is held for at least five years, then the basis in the investment is increased by 10% of the amount of gain deferred.

3. If the Qualified Opportunity Fund is held for at least 10 years, then there is no gain recognized on any appreciation in the Qualified Opportunity Fund (over and above the invested capital gains).

In addition to the tax incentives relating to the gain deferral and elimination, a cost segregation study can be used to accelerate the depreciation deductions on an asset by moving costs to shorter recovery periods. The benefit of performing a study is that it reduces taxable income in the first years of the life of the property, which frees up cash flow immediately. If the Opportunity Zone investment property is held for at least 10 years, then the increased deductions in the first years become permanent since any decrease in basis from the depreciation realized will be added back to basis.

INSIGHT:

The cost segregation technique in its current form is based on the tax court case, "Hospital Corporation of America v. Commissioner, 109 T.C 21," decided in 1997. In 2017, the tax reform changes (TCJA) made cost segregation studies more valuable than before. Under the new law, any building components with a tax recovery period of 20 years or less are eligible for 100% bonus depreciation. These components can be easily identified with the help of a cost degregation study.



A Qualified Opportunity Fund is, commonly, an investment vehicle that is organized as a corporation or a partnership for the purpose of investing in a Qualified Opportunity Zone property and which holds at least 90% of its assets in a Qualified Opportunity Zone property. Qualified Opportunity Funds, which only reinvest the investor's capital gains, typically cannot benefit from cost segregation. This is because in a partnership, the taxpayer's initial basis is zero. If the basis remains zero, then the losses from a cost segregation study cannot be used. However, a taxpayer can benefit from a cost segregation study if there is debt and/or any additional (non-Opportunity Zone) investment on top of the capital gains. Understanding the nuances of each type of debt is critical. Investors who utilize either recourse and/

"Investors who utilize either recourse and/or qualified non-recourse debt can potentially benefit from the cost segregation study as they may have increased basis."

or qualified non-recourse debt can potentially benefit from the cost segregation study as they may have increased basis. Investors and professionals involved with real estate are aware that development projects generally have significant debt. Thus, most Opportunity Zone investors can benefit from adding cost segregation to their tax planning.

The Opportunity Zone rules only apply for Federal tax purposes; therefore, if a taxpayer purchases a property with no debt, they have no basis for Federal purposes. However, this is not true for state purposes. All income would be taxable, and the entire purchase would have basis for state tax purposes. As a result, a cost segregation study may have significant benefit for state purposes.

There has been a lot of investor interest in Opportunity Zones. Hence, taxpayers and tax preparers should be aware of how they interact with other tax incentives such as cost segregation. Careful planning is vital to ensure that maximum benefits can be realized. The KROST team is well versed in the nuances and interactions of 1031 Exchanges, Opportunity Zones, and Cost Segregation. Please feel free to reach out to us if you are in a position to utilize any of these strategies. ■

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