Why Qualified Opportunity Funds Should Consider Cost Segregation

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Introduction

The passage of the Tax Cuts and Jobs Act (TCJA) in 2017 added to the Internal Revenue Code (IRC) an Opportunity Zones Program. This program provides for favorable capital gains treatment for investments in businesses and real estate investments in certain designated economically distressed areas of the United States called Opportunity Zones (OZ). These investments made into an OZ must be funded through a Qualified Opportunity Fund (QOF). This article will discuss in more detail the tax benefits associated with this new program and how to pair it with a Cost Segregation (CS) real estate investment tax strategy for enhanced tax savings.

Opportunity Zones

An OZ is an area that has been designated as an economically distressed community. Each state was responsible for nominating their own OZs, and then were later approved by the Treasury Department. Naturally, the purpose of an OZ is to drive economic development into these economically distressed areas by providing a tax benefit to investors. The tax benefits are related to capital gains of a prior investment (old gain) and the potential capital gains for the new OZ investment (new gain).

The three main benefits include the potential deferral of old gain, an upward basis adjustment resulting in a reduction of old gain, and the exclusion of capital gains on new gain. The first tax benefit is that investors who invest in a QOF with prior gains may defer their old gain until the earlier of the date on which the investment in the QOF is sold or exchanged, or December 31, 2026. The second tax benefit is if the QOF investment is held for longer than 5 years, the investor may exclude 10% of the deferred old gain from capital gains tax – while, if held for longer than 7 years the exclusion increases another 5% to 15% total (step-up in basis). The third tax benefit is a capital gain exclusion on the gain in value of the new investment since the date of investment in the QOF if held for at least 10 years. Clearly, the purpose of these benefits is to reward long-term investment in a QOF.

The TCJA requires that investors who wish to take advantage of these preferential capital gains tax rules make their investments into OZs through an investment vehicle termed a Qualified Opportunity Fund (QOF). A QOF must be set up as either a partnership, a corporation or a REIT for federal tax purposes. Therefore, investors may not invest directly into a specific project in an OZ as the deferred gains and exclusion rules are only available for investments made into a QOF.

Cost Segregation

A Cost Segregation study allows for property owners to accelerate depreciation deductions by reclassifying certain items from longer life Sec. 1250 property to shorter life Sec. 1250 and Sec. 1245 property. Generally, Sec. 1245 property is tangible personal property and Sec. 1250 property is real property that is not Sec. 1245 property. Sec. 1245 property has shorter recovery periods for depreciation purposes than that of building Sec. 1250 property. More specifically, Sec. 1245 property may be depreciated over 5 and 7 years and is often eligible for accelerated methods and bonus depreciation. Certain Sec. 1250 property is land improvements and can be depreciated over 15 years.

In general, a taxpayer benefits from a reduced current year tax liability by maximizing depreciation deductions and deferring taxes. Therefore, by using a CS study to reclassify certain property items eligible for accelerated depreciation a taxpayer can lower the tax liability in the early years of ownership. The benefit of utilizing this technique is to take advantage of the immediate cash flow generated from the tax savings, particularly the tax savings attributable to the catch-up adjustment that is often available in the year the CS study is completed for existing buildings that have utilized a straight line 27.5 or 39-year approach for all property assets. This tax strategy is advantageous for the taxpayer because they receive an influx of cash in the same year via a reduction in income taxes.

Opportunity Zones and Cost Segregation

The question is whether a taxpayer can invest in a QOF and then have the QOF utilize CS to further increase tax savings. To explore this potential scenario, we must look at the proposed regulations' treatment of gains and losses of the QOF entity, how the QOF will handle the basis of the investor in a partnership QOF, and how a QOF can be funded. For the purposes of this article, we will focus only on partnerships and will exclude corporations.

Recall that the tax benefit to the taxpayer is attached to the QOF and not individual projects in the OZ. Because of this requirement, the law was drafted with the idea that when the QOF sells property, the taxpayer's deferred gain remains unchanged as long as the QOF continues to maintain its status as a QOF under the OZ program rules and regulations. However, recently released proposed regulations state that this will not be the case for a QOF organized as a partnership for federal tax purposes. The proposed regulations conclude that preexisting tax principles regarding taxation of partnerships, specifically as it relates to a partner's capital account and basis adjustments, shall not be modified or expected to work differently simply because the partnership is a QOF.

In general, a partner's basis in the partnership is increased by that partner's distributive share of partnership debt. Having a positive basis ultimately allows for tax free distributions or depreciation deductions from the partnership. When discussing the types of debt that a partnership may take on, there are generally three types: recourse, nonrecourse, and qualified non-recourse. Understanding the nuances of each type of debt is important due to the partnership at-risk limitations of Sec. 465. This rule limits the amount of distributions a partner may take to the total amount that partner is at-risk. Generally, recourse and qualified nonrecourse debt in real estate will increase a partner's basis as it applies to the at-risk rules of Sec. 465. This is critical because the taxpayer's initial basis in the partnership will be zero. *If the basis remains zero, a taxpayer cannot use losses such as those generated from CS.*

A QOF may receive funding to make OZ investments from other sources outside of the deferred capital gain investor. QOF funding can come from regular equity influxes, certain tax credits, debt, or a mixture of these. The proposed regulations have begun to establish the guidelines for how the QOF must make investments in an OZ, the balance of OZ assets to cash or cash equivalents the QOF must maintain, and similar rules one would expect from an investment vehicle of this type. The important point for this discussion is that a QOF can mix investor deferred gains with recourse or nonrecourse debt to invest in OZ projects. If the QOF is a partnership for tax purposes and utilizes the above discussed CS strategies for maximizing depreciation deductions the investor/partner stands in a position to benefit from both the OZ long-term deferral, basis step-up adjustments and gain exclusion but also receive immediate tax savings from the accelerated depreciation deductions.

Example

This example assumes a $1 million investment. The chart below shows the general breakout of the most likely QOF funding options and shows how debt and equity affect the partner's basis in the QOF partnership.

This example will show the potential tax saving benefits of funding a QOF with each of:

(1) Prior Capital Gains only
(2) Prior Capital Gains and Debt mixture,
(3) Prior Capital Gains, Debt, and Outside Equity Mixture.

The table below shows the potential value of the prior gain deferral and depreciation deductions for a single partner in a partnership QOF. For simplicity purposes, assume the partnership has only two partners who will make the exact same funding contributions. Additionally, assume all debt is either recourse or qualified nonrecourse, all outside equity is cash or cash equivalent, and the percentage of each is equally proportionate. For capital gains rate assume the highest long-term rate of 20%.

	(1) Gains only	(2) Gains and Debt	(3) Gains, Debt and Outside Equity
Deferred Gain Investment in QOF	$1 Million	$500,000	$333,333
Debt in QOF	$0	$500,000	$333,333
Additional Equity	$0	$0	$333,333
Total Investment into QOF	$1 Million	$1 Million	$1 Million
Amount of Gain Deferral until 12-31-2026 (or Earlier if Sold)	$1 Million	$500,000	$333,333
Estimated Tax Savings of 10% Step-up in Basis (After 5 Year Hold)	$20,000 ($1 Million x 20% x 10%)	$10,000 ($500,000 x 20% x 10%)	$6,667 ($333,333 x 20% x 10%)
Estimated Tax Savings of 15% Step-up in Basis (After 7 Year Hold)	$30,000 ($1 Million x 20% x 15%)	$15,000 ($500,000 x 20% x 15%)	$10,000 ($333,333 x 20% x 15%)
Amount At-Risk (Potential Tax-Free Distribution)	$0	$500,000	$666,667

Recall that only prior capital gains are eligible to receive the deferral benefits of the OZ program. Also, the capital gains invested into the QOF initially has a $0 basis.

Using the scenarios above, let's assume that the QOF invests in a newly constructed building and parking lot with a total cost of $1 million. If the QOF doesn't do CS, the entire $1 million would be depreciated over 39 years. If the QOF does the CS, let's assume that $150,000 is moved to 5-year property and $100,000 is moved to 15-year property, both of which are eligible for 100% bonus depreciation. Clearly by doing the CS the losses are accelerated. However, can the QOF and ultimately the investors benefit from those losses? The answer lies with whether the partner has basis.

Here is what the accumulated depreciation would look like in key years with and without CS:

Time Period	Without Cost Seg	With Cost Seg
End of Year 1	$11,752	$258,814
End of Year 5	$114,316	$335,737
End of Year 7	$165,598	$374,199
End of Year 10	$242,521	$431,891

Here is what the basis would look like in each of the three scenarios in Year 5, recalling that the deferred gain gets a 10% step up in basis in Year 5:

	(1) Gains only	(2) Gains and Debt	(3) Gains, Debt and Outside Equity
Deferred Gain Investment in QOF	$100,000	$50,000	$33,333
Debt in QOF	$0	$500,000	$333,333
Additional Equity	$0	$0	$333,333
Total Basis in Year 5	$100,000	$550,000	$700,000

Here is what the basis would look like in Year 7, recalling that the deferred gain gets a total of a 15% step up in basis in Year 7:

	(1) Gains only	(2) Gains and Debt	(3) Gains, Debt and Outside Equity
Deferred Gain Investment in QOF	$150,000	$75,000	$50,000
Debt in QOF	$0	$500,000	$333,333
Additional Equity	$0	$0	$333,333
Total Basis in Year 7	$150,000	$575,000	$716,666

As this shows, in scenario (1) the investor doesn't even have enough basis to use all the depreciation before the CS much less with the CS through year 7. *However, if the QOF utilizes recourse and/or qualified non-recourse debt, the investor can benefit from the accelerated depreciation generated from the CS because they have enough basis.* For simplicity sake, this example excludes any other losses or taxable income from the investment.

How investors choose to structure the funding of the QOF is subjective to individual circumstances. For taxpayers facing large prior capital gains, but modest ordinary income, the percentage of funding should likely come from those prior gains to maximize deferrals. While taxpayers with modest prior capital gains, but large ordinary income, should structure funding in a manner that maximizes both the deferral potential but also ordinary income offsets from depreciation deductions maximized via CS.

Conclusion

A QOF that is organized as a partnership for federal taxation purposes and that is funded with a mixture of deferred capital gains, recourse or qualified nonrecourse debt and equity should allow for the taxpayer investor to take advantage of both the Opportunity Zone program and traditional Cost Segregation tax strategies. However, careful consideration needs to be undertaken to ensure that the benefits can be realized.