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Maximizing Tax Benefits with Opportunity Zones and Cost Segregation

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John Hoffman of Bracket Partners, Alex Bagne of ICS Tax, and Malik Javed of KBKG illustrate how to maximize opportunity zone tax benefits through judicious application of the substantial improvement test, use of accelerated and bonus depreciation, losses, loan interest, and other methods.

Opportunity zones and cost segregation are powerful strategies to help reduce and defer income taxes. This article highlights key considerations of potentially combing these strategies for commercial and residential rental real estate. As always, consult with a qualified tax professional.

Tax Benefits for Opportunity Zone Fund Investments

An opportunity zone is an area that has been designated as an economically distressed community. The purpose of an opportunity zone fund (OZF) is to drive economic development into these lower income areas by providing three main tax benefits to investors.

1. First, investors who invest in an OZF with prior gains may defer such gains until the earlier of the date on which the investment in the OZF is sold or exchanged, or Dec. 31, 2026.
2. Second, if the OZF investment is held for longer than five years, the investor may exclude 10% of the deferred prior gain from capital gains tax while, if held for longer than seven years, the exclusion increases another 5% to 15%.
3. Finally, capital gains are excluded on the *gain in value* of the new investment if the gains invested in the OZF are held for at least 10 years.

These tax benefits are for federal tax purposes. In addition, many states also participate in the program in various ways and may have additional requirements.

Substantial Improvement Test

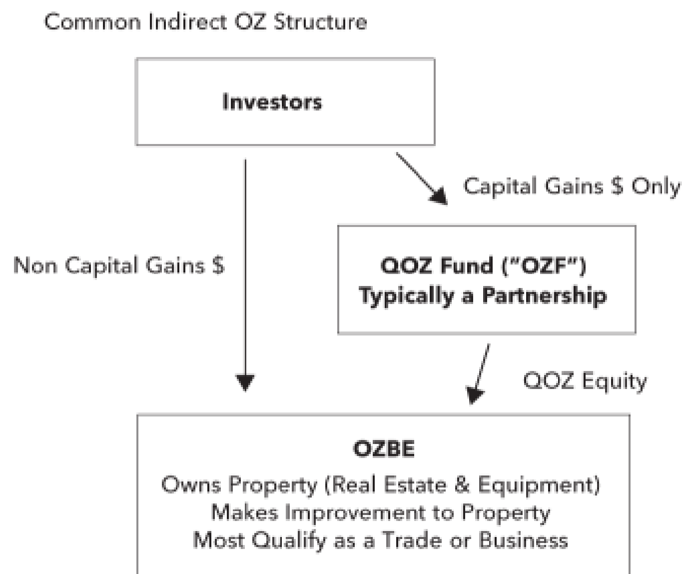
According to the applicable Treasury Regulations, property is substantially improved if, during any 30-month period beginning after the property is acquired, additions to the basis of the property exceed an amount equal to the adjusted basis at the start of the 30-month period. This period was expanded under certain applicable Covid-19 relief provisions.

Thus, OZFs do not work well for acquiring stabilized real estate unless there is the ability and desire to do a major addition, renovation, or construct additional buildings on the site. The property needs to be improved such that the cost of the improvements exceeds the tax basis of the building when the OZF acquires the property. Therefore, OZFs work extremely well for substantial rehabs of existing buildings or new construction projects.

Note that this substantial improvement test only applies to the basis of the building(s) on the site, not the personal property, land improvements, or land. Consequently, it can be beneficial to do a cost segregation study when acquiring the property to lower the building basis thereby lowering the required capital expenditures required to meet the substantial improvement test.

Common OZ Structure

Taxpayers who wish to take advantage of these preferential capital gain tax rules must make their investments into OZs through an OZF. An OZF must be set up as either a partnership, a corporation or REIT for federal tax purposes. OZFs can invest directly in real estate. However, most OZ real estate transactions are implemented with an indirect investment structure involving an Opportunity Zone Business Entity (OZBE), as illustrated below.



The OZF exists to receive capital gain dollars from investors and deploy those funds into OZ property via equity ownership of the OZBE. An OZBE is similar to a traditional real estate partnership. Capital gain dollars must go through the OZF to reap the tax benefits. Given the various tax regulations, it is generally recommended to direct non-capital gain equity funding straight into the OZBE and not through the OZF. Note that the OZF tax benefits only apply to capital gain dollars. The tax implications can be different for the OZF investors versus non OZF investors that invest traditional equity into the OZBE.

Ability to Use Depreciation and Other Losses

Qualified capital gains invested into an OZF initially have zero tax basis for federal income tax purposes (this could be different for state purposes, depending on the state). A taxpayer will need to have basis to deduct depreciation and other losses such as loan interest. Using debt to fund the OZF will give the taxpayer basis. Generally, recourse and nonrecourse debt in real estate will increase the taxpayer's basis. If the taxpayer is not using debt, a small amount of losses can be used with the 10% five-year and 15% seven-year milestone step-up in basis and the remaining losses can be used after 10 years.

If the OZBE/OZF has basis, a cost segregation study can be beneficial, because it will provide additional tax losses during the first 10 years and will increase the excludable gain after 10 years.

Post 10-year Benefit of OZ

This is by far the most valuable benefit of OZs—the ability to exclude the investment gain on sale after 10 years. This gain includes both appreciation and tax depreciation. The basis of the property can be stepped up to the FMV, meaning that any gain on appreciation is excluded and any depreciation taken over the 10 years is also excluded.

Cost Segregation and the Benefit of Accelerated Depreciation

OZ Real Estate Investment

Purchase price of vacant land	$1.0M
Total construction cost of new commercial building	10.0M
Total investment	11.0M
Increase in value over 10 years	4.0M
Value of property after 10 years	15.0M

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Without Cost Segregation

Total depreciation after 10 years	$2.5641M
Tax basis after 10 years	8.4359M
Total OZ excludable taxable gain after 10 years	6.5641M

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With Cost Segregation - Using Accelerated Depreciation

Total depreciation after 10 years (30% reclassified to shorter life)	$4.795M
Tax basis after 10 years	6.205M
Total OZ excludable taxable gain after 10 years	8.795M

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Benefit With Cost Segregation

Increase in OZ excludable taxable gain with cost seg after 10 years	$2,230,769
Additional permanent tax benefit assuming 35% tax rate	780,769

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Recall that it may make sense to do a cost segregation study on the property when acquired in addition to when it is improved.

Qualified Improvement Property

The Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act) corrected the original drafting error for qualified improvement property (QIP). In the CARES Act, QIP was specifically identified as having a 15-year recovery period, therefore rendering it eligible for bonus depreciation. QIP is defined as any improvement made to the interior of a nonresidential property after the property is placed into service. A cost segregation study will identify which improvements qualify as QIP.

Opting Out of Bonus Depreciation and Using ADS Lives or QIP for Real Property—Qualified Business Interest Deduction Under Section 163(j)

Taxpayers need to consider this interplay, because it may be beneficial to claim bonus depreciation for personal property and land improvements and then opt out of bonus depreciation for QIP. Recall that bonus depreciation can be selectively elected out for each asset class of property.

Bonus Depreciation on Acquired and New Construction

Beginning Sept. 28, 2017, Section 168(k) bonus depreciation increased to 100% from 50% for qualified property. Further, bonus depreciation was expanded to include non-original use property. This gives taxpayers the ability to claim the 100% bonus depreciation deduction on eligible used property they acquirethat was not previously in use by the taxpayer nor acquired from a related party. This can increase the OZ tax benefits.

Other Related Tax Incentives

Taxpayers may want to consider other tax incentives that could enhance the benefits of Opportunity Zones and Cost Segregation further. Some of these include:

1. the energy efficient commercial building deduction (Section 179D),
2. the energy efficient home credit (Section 45L),
3. the historic rehabilitation tax credit,
4. the low-income housing tax credit,
5. the renewable energy investment tax credit, and
6. new markets tax credits.

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Author Information

The authors are all certified cost segregation professionals (CCSP) and board members of the American Society of Cost Segregation Professionals (ASCSP). The ASCSP was established as a non-profit corporation in response to the growing need for education, credentials, technical standards, and a code of ethics within the cost segregation industry.
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