Bloomberg Tax

Daily Tax Report®

INSIGHT: Opportunity Zone Investing—How Is Debt Handled in Determining the Basis Step-up After 10 Years?

BY FORREST MILDER

A lot of investors and their tax advisors have been agonizing over how to determine the fair market value of a qualified opportunity fund (QOF) partnership interest 10 years down the road. You will remember that once the investor's holding period gets beyond 10 years, the investor can sell its interest in the fund (or, under the second round of proposed regulations, the fund can sell an asset that it holds), and elect a basis step-up to "fair market value."

It is anticipated that this will generally enable an investor to not be taxed on the sale because with the basis step-up, the sales price, and the seller's stepped-up basis should be the same. Accordingly, the sales price and basis offset each other, leaving a $0 gain on sale, and no tax. (Note that we'll leave the possible depreciation recapture issues for another day).

The problem arises because some have suggested that the fair market value of an asset should be reduced by the debt that encumbers the asset. For example, if I sell you a property with a "gross" fair market value of $100, and a debt on the property of $60, you might say that its "real" fair market value is just $40. Applying that logic to the opportunity zone 10-year rule, our seller would be getting $60 in cash and $40 in debt relief, a total of $100 of sales proceeds, but the basis step-up to $40 would leave him recognizing $100 less $40, or $60 of gain.

Now, that result sounds like it can't be right, and, if it was true, it would also make a lot of what you've heard about post-10 year sales erroneous.

And, the answer is that that result *isn't* right. Of course, our buyer isn't paying a mere $40. Instead, she's paying $40 of cash *plus* $60 in debt taken subject to, a total of $100. Indeed, she will use a $100 basis to compute depreciation deductions going forward (or use $100 for basis in computing later gain or loss if the asset purchased is not depreciable). Why would she pay $40 AND take on a $60 debt if she didn't think the property was worth $100?

Plainly, the buyer *is* paying fair market value. And that fair market value is $100, paid through a combination of cash ($40) and debt taken subject to ($60). It makes little sense to suggest that the asset she's buying has a basis to her of $100, but the seller doesn't get a step-up to the same number. Indeed, tax lawyers have heard the Internal Revenue Service complain of being whipsawed in some tax contexts, and yet that is what would happen to the taxpayers here if we concluded that at the same moment in time, the same asset had a fair market value of only $40 to seller, but $100 to buyer.

Notably, this result is consistent with the second round of regulations. Treasury Regulation Section 1.1400Z2(c)-1(b)(2) provides a "special election rule" for QOF partnerships, stating that when making the post-10 year election, "the basis of the partnership interest is adjusted to an amount equal to the fair market value of the interest, *including debt*." The subsection also provides a step-up "calculated in a manner similar to a section 743(b) adjustment" for sales of QOF partnership assets. So, we should get the same result when the QOF sells *its* assets.

Similarly, the analysis is also consistent with tax code Section 7701(g). It provides that "For purposes of subtitle A [the income tax provisions], in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject." Plainly, this provision is using the gross value method of determining the fair market value of a property subject to debt. Of course, as I noted above, this still leaves possible depreciation recapture for a future discussion.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Forrest David Milder is a partner in the law firm, Nixon Peabody, LLP, where he specializes in the tax aspects of tax-equity investing. He is a frequent speaker and author on tax-equity topics, including the Bloomberg Tax Management Portfolio, ''Rehabilitation Tax Credit and Low-Income Housing Tax Credit.'' He is a past chair of the American Bar Association's Forum on Affordable Housing and Community Development and the MIT Enterprise Forum of Cambridge. He can be reached at 617-345-1055.