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Opportunity Zones Overview: Part 2

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Part Two: Flow-Through QOF Basis Benefits

On April 17, 2019, the highly anticipated, second round of proposed regulations (the "April 2019 Proposed Regulations") were finally issued, and taxpayers were rewarded for their patience.

The primary tax benefit for a qualifying investment in a QOF is the investor's ability to step up his or her QOF investment basis to FMV if a 10-year holding period is met. The plain language of the statute appears to limit the benefit of the basis step-up to the equity interest in the QOF itself, but not the QOF's assets.

However, in the case of a QOF that is organized as a partnership, the April 2019 Proposed Regulations generously extend the FMV basis step-up benefits to the QOF partnership's assets where the investor has satisfied the 10-year holding period. First, if the investor sells or otherwise exchanges a QOF partnership interest that has been held for at least 10 years, then immediately prior to the sale or exchange, the basis of the investor's proportionate share of the QOF partnership's assets (including unrealized receivables and inventory) are also adjusted to FMV (similar to a section 743(b) adjustment) in addition to the FMV basis step-up in the QOF partnership interest.

Second, if instead of a sale or exchange of the QOF partnership interest, the QOF partnership disposes of qualified opportunity zone property, then QOF partners who satisfy the 10-year holding period may elect to exclude from gross income some or all of the *capital* gain arising from such disposition. Note, however, that although the April 2019 Proposed Regulations generally provide a 12-month period for a QOF to reinvest proceeds from the sale of qualified opportunity zone property, the Treasury Department and the IRS declined to exempt such a sale of qualified opportunity zone property from income tax consequences. As a result, if the QOF partnership were to sell qualified opportunity zone property, any partner not satisfying the 10-year holding period at the time of the sale must recognize his or her allocable share of gain or loss even if the QOF partnership were to subsequently reinvest those sales proceeds into replacement qualified opportunity zone property within the 12-month period.

The provisions above also apply to QOFs that are organized as S corporations.