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QOZ final regulations: New opportunities for estate planning

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The legislation commonly known as the Tax Cuts and Jobs Act (**TCJA**) was enacted on December 22, 2017, and after two years of IRS proposed regulations and hearings, the guidance relating to one of the biggest taxpayer benefits in the TCJA has now become final. On December 19, 2019, the IRS issued final regulations (**Final Regulations**) on opportunity zones (**OZ**). The Final Regulations improve and clarify the proposed regulations released in October 2018 and April 2019 (collectively, the Proposed Regulations). Tilting the scale at 544 pages, the Final Regulations cover numerous OZ topics, but as promised in our prior alert, this is one of several future installments wherein we drill down on specific elements of the Final Regulations. In this installment, we cover important estate planning considerations and opportunities raised by the Final Regulations.

Basic rules

We will not spend a lot of time on the basic OZ rules, but here's a quick refresher: The rules allow taxpayers to have capital gains in the current year, but defer paying tax on those gains until 2026, if the taxpayer makes an election and invests, within the prescribed timeframe, a corresponding amount of cash in a qualified opportunity fund (**QOF**). In addition to tax deferral, the OZ rules provide two other significant benefits. First, the taxpayer can get a reduction in the gain recognized if the required holding period is met (10% for five-year hold).[1] Second, if the QOF is held for at least 10 years, then gains associated with the appreciation in the QOF or the assets that it holds should not be subject to tax on disposition.

Basic rules—trusts and estates overlay

Within this basic framework of the OZ rules and the benefits to the investor, some very interesting issues and opportunities arise when we overlay estate planning techniques. The following discussion tackles some of these issues and opportunities, but first, we need to explain some of the basic rules as they apply to trusts and estates and the clarity provided by the Final Regulations.

[1] There was an additional 5% reduction for a seven-year-hold period. However, this reduction is no longer available for investments made after 2019, because the tax accrues on December 31, 2026, and that date is less than seven years from now.

Inclusion events

Key to the benefits of the OZ rules is to hold the QOF for the five-year period without having what is called an "inclusion event." An inclusion event will trigger the deferred gain earlier than the end of 2026 so that some of the benefits of the OZ rules would be lost.

Because many estate planning techniques involve the transfer of current and future interests in property, determining what constitutes an inclusion event is an important threshold question.

The Final Regulations give little relief for transfers of QOF interests by gift, with the important exception of gifts to grantor trusts. Despite requests from those commenting on the Proposed Regulations, the Final Regulations make clear that gifts to any person or entity other than a grantor trust are inclusion events.

In contrast, death is not an inclusion event and, as such, the consequences of holding the QOF pass to the ultimate beneficiary, including, importantly, tacking of the decedent's holding period. The Final Regulations make it clear that the intermediate steps that lead to the ultimate beneficiary getting the QOF also are not inclusion events. Thus, transfers concomitant to death, such as transfers to a decedent's estate or trust pursuant to the terms of the decedent's will or applicable state law, are also not inclusion events.

There are potential drawbacks. Although these transfers are not treated as inclusion events, the deferred gain (and other income amounts relating to the QOF) will not receive a Section 1014 step-up in cost basis at the decedent's death, but rather the deferred gain associated with the QOF will be includible in the recipient's gross income as provided by Section 691 upon a subsequent inclusion event, or on December 31, 2026, as with most deferred gains. To the beneficiary, this amount is referred to as "income in respect of a decedent" (**IRD**), and while income tax may be payable depending on the holding period, some relief may be available to the extent the decedent's estate paid federal estate tax on the QOF. Nonetheless, as noted above, and discussed below, the OZ rules provide a different basis step-up that may more than offset the loss of the Section 1014 step-up.

Keep in mind, however, that IRD treatment only applies to the "qualifying" portion of an investment, so to the extent a QOF is comprised of both a qualifying and a nonqualifying investment, the nonqualifying portion will receive a Section 1014 step-up. For example, if a taxpayer had qualifying gains of $120, but invested $200 in a QOF, then he would have a mixed-fund investment, with 40% (80/200) being nonqualified (for OZ purposes) and this portion would get the benefit of the Section 1014 step-up upon the death of the taxpayer. In contrast, 60% of the QOF interest (120/200) is qualified for OZ purposes but does not get the benefit of the basis step-up of Section 1014. Instead, it retains its zero basis under Section 1400Z-2(b)(2)(B), but it would be eligible for the basis step-up relating to the five-year holding period. The denial of the Section 1014 step-up is a potentially negative factor that the estate planner should consider in the event that the QOF has appreciated in value. However, as noted in the next section, the additional basis step-up on dispositions after 10 or more years that applies only to the qualifying portion of the investment presents a new opportunity for trusts to obtain a Section 1014-like benefit with respect to their OZ investments.

Over the life of a QOF, the value could go up and down, and the investor should know about the consequences of these fluctuations. Thankfully, the OZ rules provide a cap on the amount of gain recognized as a result of holding the investment on the December 31, 2026 trigger date, or at the time of an inclusion event, if sooner. The rule is that gross income includes the excess of the lesser of: (i) the deferred gain or (ii) the excess of the fair market value of the QOF, over the taxpayer's basis in the investment. Thus, if the value of the QOF goes down, the investor at least gets a tax break from the reduced tax liability. In any case, if on the December 31, 2026 trigger date the value of the QOF exceeds the investor's basis (which is likely unless the QOF value has decreased by more than 90%), the investor could have "phantom gain" (a taxable event without any distribution of cash to pay the tax). This will also be the case in those instances where an inclusion event does not result in the taxpayer receiving sale proceeds, such as with most gifts. Therefore, it is important for investors and their advisors, including estate planners, to consider putting measures in place to cope with the need for cash at a time when no cash is being generated.

Although technically not an inclusion event, a sale or exchange after 2026, but prior to satisfying a 10-year holding period, means the taxpayer doesn't get the benefit of the no tax on disposition rule. The Final Regulations make clear that this result applies for gifts (other than gifts to grantor trusts) as well, by stating that "a donee is not eligible to make an election under Section 1400Z-2(c) to adjust the basis of the interest in the QOF to fair market value."

Trusts as OZ investors

Before we get into the details of OZ investing as an estate planning tool, we should start with a discussion of certain kinds of gift-giving.

Using a grantor retained annuity trust (GRAT) or an intentionally defective grantor trust (IDGT) to make investments in QOFs can turbocharge classic "estate freeze" techniques by introducing a unique basis step-up opportunity. These techniques have long been known as effective tools for removing the appreciation on the transferred property (and the transferred property itself in the case of an IDGT) from the grantor's taxable estate at the cost of losing the Section 1014 basis step-up on the transferred property at the grantor's death. However, if the trustee invests in QOFs and the investment is held for at least 10 years, then the basis of the QOF is stepped up to fair market value, not at the time of the grantor's death, but at the time of sale, provided the 10-year period has elapsed (or even beyond, up to 2047). An example of this is provided below.

The first technical issue to tackle is making the investment in a QOF, and that means understanding the application of the 180-day deadline as it applies to capital gains of trusts. The Final Regulations treat grantor trusts and non-grantor trusts differently. Because the grantor of a grantor trust is treated as the owner of the trust property for federal income tax purposes, the regulations logically conclude that the regular 180-day rule applies to grantor trusts looking to invest gains generated by the trust just as if the grantor, personally, was reinvesting the gains. In contrast, in the non-grantor trust context, the beneficiaries are treated like partners in partnerships or shareholders of S corporations and are given the option to treat the 180-day period as commencing upon the date of sale, the end of the tax year, or due date of the entity's tax return, <u>not</u> including extensions.

The second technical issue is actually making the election and paying the subsequent tax. The Final Regulations provide that for a grantor trust, either the trust or the deemed owner may make the election, whether or not the gain is distributed to the deemed owner of the trust. As noted above, in the grantor trust context, the grantor should be particularly mindful of how it will pay the tax on the phantom gain that arises in 2026 (or earlier if there is an inclusion event). Remember that in most cases, the grantor will have little or no access to the trust principal. Because of this, estate planners should consider including discretionary tax reimbursement provisions in trusts intended to hold QOFs.

Lastly, trustees need to be mindful that during the time the trust owns the QOF, a pre-death conversion from a grantor trust to a non-grantor trust or vice versa is an inclusion event, whereas conversion of the grantor trust into a non-grantor trust at the grantor's death is not. Furthermore, and particularly with respect to grantor trusts that convert to non-grantor trusts upon the grantor's death, trustees should be cautious as to whether a distribution of a QOF to a beneficiary not otherwise mandated by the terms of the trust will constitute an inclusion event that otherwise could be avoided by continuing to have the QOF interest held by the trust. In other words, upon the death of the grantor, when the grantor trust becomes a non-grantor trust, there is a concern, created by the unclear wording of the Final Regulations, that subsequent discretionary distributions by the trustee could constitute inclusion events if such distributions are not mandated by the terms of the trust.

Let's take a look at two illustrations of a GRAT and IDGT without a QOF investment, and then we can explain how to "turbocharge" them with a QOF investment.

Example 1 — The basic Grantor Retained Annuity Trust (GRAT): no QOF

Let's say Jane has a highly appreciated stock portfolio and relies on its dividends for a portion of her retirement income. She expects the portfolio value will continue to increase in value, and she would like her children to benefit from that appreciation and for the appreciation to accrue outside her taxable estate. However, in order to ensure a comfortable retirement, she isn't ready to give them the entire account. Jane can achieve her goal by creating a GRAT—a trust in which she retains an annuity interest for a set period of time and has the remainder held in trust for her children. Jane can structure the annuity payments so that they approximate the present value of the portfolio at the time she makes the gift, adjusted for the then-current applicable federal rate of return. By structuring the GRAT in this way, there is little to no gift tax consequence to funding the GRAT because Jane will get back what she contributed, yet all of the growth will pass to her children free of gift tax. One problem with the GRAT is that if Jane doesn't end up spending all the annuity payments she receives, those assets will be subject to estate tax at her death. Furthermore, if Jane dies while the GRAT is still making annuity payments to her, she runs the risk of having her initial contribution and a portion of the appreciation included in her taxable estate, defeating her planning objectives.

Example 2 — Intentionally Defective Grantor Trust (IDGT): no QOF

Upon further reflection, Jane decides that she has adequate assets outside of the portfolio and that she is comfortable giving away the entire account. With these new facts in mind, the estate planner suggests that Jane create an IDGT, which resolves some of the uncertainty and tax exposure tied to the GRAT. The trust must be carefully drafted so that Jane retains just enough power over it to ensure it will be treated as a grantor trust (e.g., the power to substitute her own assets for trust assets of equal value), but not so much power that the trust assets will be included in her taxable estate. With this structure, the portfolio and all of its future appreciation will not be included in her taxable estate, and, instead, it will be held in trust for her children's benefit.

Keep in mind that because both the GRAT and IDGT are grantor trusts, Jane will continue to pay the income tax on the portfolio dividends, interest, and capital gains. While at first blush this income tax liability may seem like an undesirable result, those tax payments do not constitute gifts from Jane to the trust, so by paying the taxes, she essentially enables the trust to grow tax-free without triggering any additional transfer tax, all the while spending down her own taxable estate—a great result.

Using a QOF to turbocharge the results

Jane's savvy trusts and estates lawyer explains that the GRAT or IDGT can diversify its asset mix by selling some of its assets to generate capital gains and then investing that amount in a QOF.[2] By doing so, not only will Jane get the two basic benefits of the OZ rules: (i) deferral of tax on such capital gains and (ii) reduced capital gain (if the five-year holding period is met), but she can also get a tax basis step-up in the QOF assets if they are held for 10 years or more.

This is important enough to state again: Losing the Section 1014 step-up is generally viewed as a cost of using irrevocable trusts like a GRAT or IDGT, but now an equivalent step-up can be available for long-held QOF assets. So, Jane can get deferral, reduction in capital gains, and a step-up in basis, not to mention diversification, which may be particularly appealing to her trustee who is looking to increase the trust's exposure to alternative investments. As discussed above, because the Final Regulations make it clear that neither the current gift nor the conversion of the trust from a grantor to a non-grantor trust at Jane's death will trigger an inclusion event, even if Jane dies before the 10-year holding period has run, the trust will be eligible for the full FMV step-up on the appreciation if the trust holds the QOF for the requisite period.

Using leverage

We can get an even better result by adding leverage to the IDGT example. Instead of making a gift of the QOF to the IDGT, let's consider what happens if Jane makes a small cash gift to the IDGT, and the IDGT uses some of the cash as the down payment to purchase Jane's QOF interest. The IDGT consequences are well-defined: so long as the down payment is at least 10% of the purchase price and the IDGT gives Jane a proper interest-only, payable-on-demand promissory note, the only taxable gift is the initial transfer of cash (as opposed to the fair market value of the stock portfolio contributed in the prior IDGT example (or QOF assets in the alternative example of footnote 2)). The "sale" to the IDGT is completely disregarded for income tax purposes since under the grantor trust rules Jane can't be taxed on a sale to herself. Jane now gets regular interest payments on the promissory note and can even demand a repayment of some of the principal if such interest payments are insufficient to meet her needs. At the same time, the trust's assets, consisting of the full value of the QOF, net of the payoff of the note, are held for the benefit of her children with no additional transfer tax at Jane's death. If the trustee buys life insurance on Jane's life to fund the eventual payoff of the note, the death benefit will also pass to Jane's children outside her taxable estate.

CAUTION: don't try doing this without qualified professional help. It's a well-travelled path for an experienced estate planning lawyer (except for the new QOF aspects), but it's complicated, and missing one step can defeat the entire plan. For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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[2] Alternatively, Jane could sell some capital gain property held directly, invest in a QOF, and then contribute those interests to the trust.