Investing In Qualified Opportunity Funds with Irrevocable Grantor Trusts

A Powerful Combination to Reduce Taxes

By Michael Kelley and Michael Gershon

For many families, estate planning is driven by a desire for reassurance that the assets they have built will be in place for future generations. Until recently, families acquiring long-lived appreciating business or real estate interests had to choose from several highly imperfect estate planning strategies. That changed when the U.S. Treasury's now finalized opportunity zone (OZ) regulations opened the door for combining investments in qualified opportunity funds (QOF) with irrevocable grantor trusts (IGT), giving families a potent new tool to pass appreciating assets through generations while saving on taxes.

A Powerful Pairing

IGTs and QOFs work well together, as both are suited for investors with substantial time horizons. The real attraction for pairing the two is that one's weakness is the other's strength. IGTs are great at protecting assets from estate taxes and unforeseen circumstances, but at the same time, they leave families vulnerable to elevated capital gain tax liability. Qualified investments in OZs, however, can eliminate these capital gain liabilities until 2047.

IGTs Explained

The major benefit of IGTs is that they legally remove assets from the donor's estate. This allows families to pass assets through generations with protection from such perils as unforeseen lawsuits, estate taxes, and medical expenses. They have proven to be highly effective in shielding both the trust's grantor and its beneficiaries from claims on assets.

These attributes have made IGTs a staple of estate planning, but this protection carries a heavy cost in the form of an elevated capital gains tax liability. Normally an asset, such as real estate or a family owned business, would receive a step-up in basis to the current fair market value on the passing of the owner. Each generation would inherit the asset at a fair market value basis, leaving it free of capital gain liability.

Unfortunately, assets held in an IGT are not eligible for the step-up in basis because they are no longer considered part of the estate. This leaves beneficiaries with the possibility of having a low cost basis that could be decades old, and the potentially huge capital gain liability that comes with it.

Opportunity Zone Initiative

The Tax Cuts and Jobs Act of 2017 (TCJA) created the OZ initiative, which offers significant tax benefits for reinvesting capital gains into eligible neighborhood census tracts. The program is designed to encourage long-term capital investment in struggling neighborhoods by driving enough new capital into these communities to kick-start their economies.

Perhaps the most unique feature of the OZ initiative is that, unlike tax credits, there is no application and no months of waiting for approval. Investors only need to comply with the initiative's guidelines, and they can receive the OZ tax benefits without limit.

There are three main requirements to qualify for OZ benefits: 1) eligible capital gains, 2) eligible investment, and 3) benefits based on holding periods.

Eligible capital gains. To qualify as eligible, capital gains must be invested in a QOF within 180 days of being realized, or if the capital gain comes from a pass-through entity, within 180 days of the last day of the pass-through entity's taxable year *or* within 180 days of the due date of the pass-through entity's tax return (without extensions). Importantly, unlike Internal Revenue Code (IRC) section 1031 exchanges, the funds are not traced, and there is no need for an intermediary to hold the money. In addition, unlike 1031 exchanges, if the capital gains are realized in a pass-through entity, either the pass-through entity or the partners/shareholders can make the investment in the QOF.

For example, if the capital gains are cashless, then another source of capital, or even money from a loan, could be used to make a qualifying investment. The important thing is to have a realized capital gain and get money representing it into the QOF within 180 days.

Eligible investments. A qualifying investment must be made in a trade or business. This can include an operating business or real estate business.

In most cases, at least 70% of the business's tangible assets must be "good assets," meaning they are new assets in the OZ. They can be newly bought, leased, or moved into the OZ. In addition, 50% of the gross income must be earned in the OZ. The 50% gross income test is met if any of the following four criteria are met:

- 50% of employee hours worked must be in the OZ. Personnel based in an OZ who visit areas outside the OZ in the course of their work would need to document the hours worked in and out of the OZ.
- 50% of employee compensation must be from workers based in the OZ.
- The tangible property in the OZ and the management or operation functions performed in the OZ are each necessary for the generation of at least 50% of the gross income of the trade or business.

There is also a facts and circumstances test, which acts as a catch-all for businesses that operate within the spirit of the OZ incentive but have unusual circumstances. Qualifying real estate investments in the OZ must pass one of the following two criteria:

- Original use, meaning the investment is brand-new construction that has not yet been placed into service or a building that has been vacant for at least three years
- Substantial improvement, meaning that the capital investment made into an existing building must be at least equal in value to the value of the existing structure, not including the land.

Benefits based on holding period. There are three benefits for qualifying investments, all of which are achieved based on the investor's holding period:

- Deferral of the original capital gain liability for as long as the investment is held, or until December 31, 2026.
- A step-up in basis of 10% of the original capital gain deferred after the investment is held for five years. Note that for investments that were made by December 31, 2019, there is an additional 5% step-up after the investment is held for seven years.
- After 10 years, the investment qualifies for a 100% step-up in basis for as long as the investment is held, provided it is disposed of by December 31, 2047.

The first two benefits apply to the original capital gain liability; they can be thought of as the equivalent of a seven-year loan with 15% principal forgiveness on the original capital gain liability. The third benefit is by far the most powerful, and it is this benefit that works so well with IGTs.

The OZ incentive itself is huge. There are more than 8,700 OZs, and according to research done by the Economic Innovation Group, $6 trillion of capital gains are potentially eligible for this tax benefit ("Opportunity Zones: Tapping into a $6 Trillion Market," Economic Innovation Group blog, Mar. 21, 2018, http://bit.ly/2QL5JKG).

Exhibit
Using an Irrevocable Grantor Trust with a Qualified Opportunity Fund

	Current Business Valuation	Basis at Sale	Sale Price in 25 Years (2044)	Capital Gain Liability	After-tax Value
Irrevocable grantor trust	$15,000,000	$5,000,000	$105,000,000	$20,000,000	$85,000,000
Irrevocable grantor trust and opportunity zone investment	$15,000,000	$105,000,000	$105,000,000	$0	$105,000,000
Tax savings					**$20,000,000**

New Guidance

The Treasury's guidance paved the way for pairing OZs with IGTs by clarifying that a gift to an IGT would not be an inclusion event of the deferred gain. In other words, it is a nonevent for tax purposes, and the OZ benefits would remain in place. In addition, the guidance specifies that upon the grantor's death that the benefits of the QOF investment would remain intact for the beneficiary, including the donor's holding period.

How It Works

Assume a couple uses a $5 million capital gain plus $10 million in debt to buy a business for $15 million dollars, utilizing the benefits of the OZ initiative. They believe the business is poised for significant future appreciation. Including all assets, the couple is over the $22.8 million estate tax threshold, so they decide to buy the business through a QOF structure and gift the interest in the QOF, which holds the business, into an IGT to protect the asset for their children. In addition, when the original deferred and reduced capital gain taxes come due in December 2026, the couple can choose to pay them from their estate to effectively let the asset grow income tax–free for the next generation while further reducing their taxable estate.

Gifting the business to an IGT means the asset's future appreciation will not be subject to the 40% estate tax and the asset now enjoys protection from claims against both the trust's donors and beneficiaries. Unfortunately, moving the asset out of the couple's estate means their children will not receive a step-up in basis upon inheritance.

The biggest benefit of the OZ incentive is realized when the QOF interest containing the business is eventually sold before December 31, 2047, and any appreciation in value that would have been subject to the 20% federal capital gains tax is erased. The *Exhibit* assumes the investment grows at 8% annually and is eventually sold by the children in 2044. It uses the current federal capital gains tax rate of 20%.

Pairing irrevocable trusts with OZ investments can clearly be a powerful estate planning tool, and not just for ultra–high-net-worth families. For example, assume a couple with a net worth of $1 million buys a business with attractive long-term growth prospects that is currently worth $250,000. They wish to eventually pass the business on to their children, but they are concerned that medical bills, lawsuits, or other unforeseen circumstances could drain their estate and force the sale of the business. The pairing of an IGT with the OZ incentive would deliver the same asset protection and capital gains tax elimination as in the earlier scenario.

Preexisting OZ Investments

The spirit of the OZ legislation is to bring in new capital and new investors to qualified distressed areas. As a result, there is an additional requirement that a purchase transaction must be from an "unrelated party" for an asset to qualify. This puts current owners of assets in opportunity zones seemingly at a disadvantage.

It is difficult for legacy owners OZ operating businesses to qualify. Because 70% of the business's assets must be new to the OZ, substantial expansion of the business's tangible assets would be required. There are, however, several potential ways for legacy OZ real estate owners to benefit:

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■ In some (but not all) OZs, property values have appreciated as a result of the designation. The OZ bump in land prices can be a benefit for those willing to sell.

■ Landowners can agree to a lease with a QOF that they own. The QOF in this scenario is considered a separate entity from the lessor. Because this is a related party transaction, there are additional requirements. First, the lease must reflect fair market pricing and cannot be paid more than 12 months in advance. Second, the leased asset must meet either the original use or substantial improvement tests. In this structure, for example, a landowner could own both a parcel of land and 100% of the QOF that is leasing it. The land would not receive the OZ benefit, but an apartment building (or whatever else the QOF chooses to build) would qualify.

■ In addition, owners of both OZ-operating businesses and real estate could potentially sell to and then invest in the QOF. They would need to stay below 20% ownership of the QOF to meet the unrelated party requirement. The capital gain could not arise from the same asset being sold to the QOF. Any circular movement of money from the QOF to the seller back to the QOF would not yield eligible gain; however, capital gain from another source would in most cases be eligible.

Checklist for Pairing Qualified Opportunity Zone Investments with Irrevocable Grantor Trusts

☐ Estate trust planning can take many forms, so explore all options.

☐ Make sure to understand the compliance guidelines and many potential estate planning uses for qualifying opportunity zone investments.

☐ Check for state and local opportunity zone incentives. Many area governments have added additional incentives to attract opportunity zone capital.

☐ Keep current on opportunity zone news. The U.S. Treasury released final opportunity zone regulations on December 19, 2019, but there is always potential for further interpretations of the regulations.

Seize the Opportunity

For families with assets in one of the 8,700 OZs across the country, as well as those considering purchasing OZ assets, these new estate planning techniques are a great opportunity. Combining the attributes of IGTs with QOFs provides a powerful new way to guide and protect appreciating assets for generations to come. ❑

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