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2023 Estate and Gift Tax Conference

Dealing With Difficult Entity and Real Estate Issues

Friday, March 10, 2023
8:30 am - 9:30 am

Speakers:

Minna Yang

Belan Wagner

Conference Reference Materials

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Dealing With Difficult Entity and Real Estate Issues

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With over 40 years of in-depth experience in business, taxation, real estate, estate planning and controversy work, coupled with the support of other firm lawyers, Belan has developed a unique practice designed to provide multi-dimensional legal services to the business owner, executive or individual who must comply with today's complex legal system. Belan provides direct representation to clients as well as acting as an expert resource to client's primary attorneys, accountants, financial advisers and other representatives

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Minna Yang is a partner with Wagner, Kirkman, Blaine, Klomparens & Youmans LLP. With over 30 years of extensive experience, Minna is a member of the Business Transactions department which practices in the areas of taxation, business matters, real estate, estate planning and probate. Ms. Yang not only provides direct representation to clients, but serves as a practiced resource to client's primary accountants, financial advisers and other representatives.

Minna also assists clients and companies with matters including owner relationships, mergers, acquisitions, sales, exchanges, financing and debt restructuring including foreclosures, leases, partnerships, joint ventures and broker--agent relationships. She also specializes in related insurance planning and general business law. Her services provided include, but are not limited to, acquisitions, sales, 1031 exchanges, financing, reorganizations, debt restructuring, leases, partnerships, joint ventures, options, licenses, easements, development agreements, cost sharing agreements and various types of transactions related to real estate ownership.

Real Estate, Entity Selection and Estate Planning

Real Estate, Entity Selection and Estate Planning

- Due to the uncertainty of our tax regime in the near future, real estate ownership and entity issues routinely arise in common estate and business planning transactions and will remain an important aspect of a successful estate plan.

- Income tax issues, uniquely important with regard to real estate, are often overlooked in situations where saving estate and gift taxes are the focus of the planning.

- Historically, estate and gift tax rates usually exceeded the income tax rates. The lifetime estate and gift tax exclusions was often substantially less than the now $12.92 million, indexed for inflation which is scheduled to be drastically reduced in 2026. Tax rates remain high for certain entities and have decreased for others.
- Real estate planning and entity selection in conjunction with estate planning is more important than ever.

Step-Up and Portability

Step-Up and Portability

- Currently, property, including real estate, acquires a new fair-market-value "fresh-start" basis when the property passes to an heir or beneficiary at the property owner's death.
- In community property states, including California, both halves of the community property are entitled to a step-up in basis.
- ***With regard to real estate, a stepped-up basis not only means no/reduced gain on sale, but it means increased depreciation expense, i.e., reduces income taxes.***
- However, if property is gifted to an heir or beneficiary, there is no step up in basis.
- Prior to "Portability" a "tax free" trust (e.g., Bypass Trust) was always preferred to a "tax deferred" trust (e.g., QTIP Trust).
- Now, a dilemma is whether it is better to gift and use fractional discounts or leave to heirs at death and receive a step up.
- In taxable estates in excess of the lifetime exclusion, gifting is typically preferable.

Step-Up and Portability

Higher estate tax exclusions; portability of the exclusion; income tax rates (Federal & State plus possibly the 3.8% surtax), that may exceed the Federal Estate Tax rate of 40%, but this may not last:

Handling tax basis of assets:

- Income tax basis of assets (other than certain assets {IRD assets} such as IRA's and 401(k) accounts) get stepped up to date-of-death fair market value when the owner dies.
- With estate exclusion being so high, tax basis is often the more significant consideration.

Estate tax exemptions:

- In 2012, many worried that the $5,000,000 Federal exclusion would drop to $1,000,000.
- However, the $5,000,000 was extended and indexed.
- Then as part of the Tax Cuts and Jobs Act (TCJA) of 2017, the exclusion was doubled (for eight years) resulting in a $12,920,000 Federal exclusion for 2023.

Step-Up and Portability

Now that we have portability and higher exclusion, we can often achieve similar estate tax savings with portability and can obtain a second basis step up at the survivor's death by not utilizing the bypass trust.

- For combined estates under two (2) times the Federal exclusion, control and asset protection can become a more important trust design factor, i.e., entity selection.
- For estates expected to be over (but not way over) two exclusions, designing the trust can be more difficult due to dealing with the anticipated drop in 2026 or the potential acceleration in drop before 2026.
- The DSUE (the deceased spouse's unused exclusion) is capped at the time of the first death and assets continue to appreciate for estate tax purposes.
- ***For larger estates, consideration should be given to using DSUE during the survivor's lifetime to establish an irrevocable grantor trust with a "swap power" under IRC § 675(4)(C).***

Step-Up and Portability

Example:

- "Harry and Wanda" H & W, new clients, come into your office, on or after June 12, 2015 (the effective date of the final Portability Regulations) and have not updated their living trust since prior to 2011.
- They have modest real estate holdings, but the property has significantly grown in value over the years (as have their other assets).
- Assume that H & W have a traditional A-B-C trust , a standard form of trust prior to portability.
- The exclusion has gone way up and portability is "permanent".

Step-Up and Portability

Example (continued):

- Assuming H dies first (becoming the "deceased spouse"), and his exclusion is "ported" to W, if W remarries ("New H") and New H also dies before W, then W loses the original DSUE from H (unless she's used it for gifting) and New H's DSUE is what W ultimately receives.
- With a traditional A-B-C trust, assume H & W have a combined trust estate of $10,000,000+, all community property:
  - Since $5,000,000 is below the indexed exclusion ($12,920,000 for 2023), their existing A-B-C Trust would result in an A-B Trust if H dies. All of deceased spouse’s interest passes to the B Trust.
  - The result is no 2nd basis step up at W's death for assets in the B Trust.

Step-Up and Portability

Eliminating the B Trust:

If we could be certain that the estate would not be subject to estate tax at the survivor's death, then we could advise H & W to set up a trust that looks very much like their existing trust, the A-B-C Trust, but just removes the B Trust. (Or in the case of a common law property estate, a single QTIP Trust, would be funded after the first death).

- What if (1) H dies in 2023, when the exclusion is $12,920,000 (2) W claims $12,920,000 DSUE; (3) W does not remarry; and (4) W lives past 2025.
  - Will part of the $12,920,000 DSUE be cut back ("clawed-back") in 2026 when the exclusion is scheduled to drop by 50%?
  - The answer is no based on Anti-Clawback Prop. REG 106706-18.

- What about an "unnecessary QTIP"?’
  - We now know that pre-portability Rev. Proc. 2001-38, will not prevent a couple from omitting a Bypass Trust in favor of a QTIP Trust even if the deceased spouse's estate is below the estate tax exclusion, Rev. Proc. 2016-49.

Step-Up and Portability

- GST Exemption. While the DSUE will be needed for the QTIP trust which is included in the surviving spouse's estate under IRC § 2044, the QTIP trust can (generally) be made GST exempt by making a reverse QTIP election.
  - Similar to the B Trust, the QTIP Trust can have a zero inclusion ratio for GSTT purposes and provide a certain level of asset protection. But unlike the B Trust, the QTIP Trust assets will receive a new basis step up (or down) at W's death. The QTIP Trust will pass entirely estate tax free or partially estate tax free (or possibly be fully taxable if there is a new last deceased spouse who has no DSUE to port).
- But if (1) is a $10,000,000 community property trust estate at 1st death; (2) W does not remarry; (3) exclusion does not change (other than annual indexing); and (4) indexing of W's exemption keeps pace with the growth of the combined estate, then the A-C Trust will have provided a superior tax result to the A-B Trust (if there has been appreciation in the assets held in the QTIP Trust).
- Alternatively (particularly if it is a first marriage for H & W), they may opt for simplicity (portability and outright {or in revocable trust} for survivor) but this is often problematic due to the surviving spouse’s ability to change the disposition.
  - Note that portability must be elected on timely filed IRS Form 706.
  - In some cases a simplified 706 may be used.

Technical Requirements of Portability

- Deceased spouse;
- Deceased spouse must have unused exclusion;
- Only the unused exclusion carries over to the surviving spouse;
- If there is more than one deceased spouse, only the remaining exclusion of the later spouse to die can be carried over (the statute calls this person the "last deceased spouse");
- A portability election can be made on a properly prepared Form 706 on or before the fifth anniversary of the decedent’s date of death if filed pursuant to Rev. Proc. 2022-32, else a PLR is likely required.
- Once made (on the 706), the portability election is irrevocable.

IRC Sections 2022A, 6166, and 469

Special Use Valuation - IRC Section 2032A

- IRC § 2032A is used to reduce the value of real estate for estate tax purposes from highest and best use (the normal test) to actual use if the property is used for farming (or in another trade or business).
- IRC § 2032A requires continued usage of the property in the farming operation (or in another trade or business) by a "qualified heir" for ten years after the decedent's death.
- There are percentage tests that must be met: essentially 50% of the value of the estate must consist of property used in the business of farming or other business and 25% of the value of the estate must consist of real property used in the business of farming or the other business.
- The maximum reduction in value (for 2023) under IRC 2032A is $1,310,000. Courts are split over whether Special Use Valuation and valuation discounts are mutually exclusive.
- This is not used much right now because of the $12,920,000 lifetime exclusion.

IRC Section 6166 Requirements

- IRS § 6166 allows the Estate and GST Tax payments to be deferred and paid in installments to the extent attributable to the value of a closely-held trade or business.
- If the estate qualifies and the election is made, the first installment of tax is due not later than 4 years and 9 months from the date of death and the remaining installments are paid over a period of 10 years (nearly 15 years to pay).
- The nearly 15 year payment period is extremely helpful due to the lack of liquidity relating to closely held businesses and/or real estate.
- Gross estate must included an interest in a "closely-held" business the value of which exceeds 35% of the adjusted gross income.
- Aggregation of business interests is allowed; provided:
  - Decedent owned 20% of the total value; and
  - each activity otherwise qualifies as a closely-held trade or business.

IRC Section 6166 Requirements

- To qualify as an interest in a closely-held business, the interest can be as a sole proprietorship, partnership, or corporation.
- Partnership will qualify if 20% or more of total capital interest in partnership is included in determining gross estate of decedent or partnership has 45 or fewer partners.
- Stock in corporation qualifies if 20% or more in value of voting stock is included in determining gross estate of decedent or corporation has 45 or fewer shareholders.

IRC Section 6166 Requirements

- Definition of “trade or business” means business must be:
  - Actively carried on; and
  - Require a management function.
- Active asset rule:
  - No deferral for passive assets; and
  - Only active assets are considered.
- Rental real estate is per se passive
  - However, what about Qualified Real Estate Professionals (IRC § 469)?

Qualified Real Estate Professional

- Rental Real Estate is *per se passive* and therefore would not qualify for certain tax benefits including IRC § 6166 deferral and exclusion from Net Investment Income Tax ("NIIT") pursuant to IRC § 1411.
- IRC § 469(c)(7) treats certain rental real estate as non-passive.
- Treas. Regs. 1.469-5T(a)(1) Safe Harbor allowed.
  - More than one-half of the personal services performed in trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates; and
  - The taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates.

Qualified Real Estate Professional

Trustee Participation:

- **IRS:** Material participation by non-grantor trust depends on trustee's activity, not its agents (or special trustee). See also TAM 200733023; PLR 201029014; TAM 201317010.
- Carter Trust v. US 256 F. Supp. 2d 536 (N.D. Tex. 2003). Trustee hired ranch manager. Material participation found through employees and trustee.
- Aragona Trust v. Com'r, 142 TC. 9 (3/27/14). 3 of 6 trustees (related) worked FT for R/E management LLC, wholly owned by trust. Trust can materially participate through trustee-employees; **Real Estate professional exception applied**.

Entity & Ownership Structure

Tax Advantages & Disadvantages of Various Entities

Each type of entity structure may have benefits and disadvantages when considering income tax and estate planning goals. Examples include:

- Partnerships and LLCs. The IRC § 754 election to allow inside basis step up often tips the scale in favor of the partnership and LLC.
- C Corporations. There may be a temptation with the lowering of the Federal "C" corporation tax rate to 21% as provided in the TCJA to rush to the "C" corporation.
- Pass-Through Entities.
  - In most scenarios using a pass-through entity and taking an IRC § 199A deduction will produce more "net" to the owners. It is true that 199A is set to sunset at the end of 2025.
  - The flow-through nature (generally single level income tax) of the LLC taxed as a partnership and the flow through nature of the "S" corporation often make these choices the most attractive.
- S Corporations. "C" corporation versus "S" corporation is strictly a tax distinction. If a corporation meets the requirements (really limitations) to be an "S" corporation, then the shareholders can make an "S" election by filing IRS form 2553. This limits the number of shareholders (100). Only certain trusts are eligible to hold "S" corporation stock.

Using Entities to Achieve Discounts

- Ownership of assets, including real property through an entity usually results in a valuation discount.
- In the age of higher estate tax exemptions (Federal $12,90,000 for 2023), discounts can be a bad thing, reducing basis step up at death.
- Valuation adjustments (discounts), e.g., lack of marketability and minority interest discounts:
  - Frequently achieved by having the real estate in an LLC or other entity and fractionalizing the ownership of the entity.
  - Some recent cases have put a cloud over using the family limited partnership (FLP) or family limited liability company (LLC) as a vehicle to pass on family wealth to the next generation.
  - The recent IRS challenges are typically directed at passive assets, not active trades and businesses or where the entity was not respected.
  - It is important to have a business purpose for formation of the entity.
  - Consider gift stacking if not using both spouse's entire exemption amount.

Death of a Shareholder

Death of C or S Corporation Shareholder

- Heirs/Beneficiaries enjoy step-up in stock basis.
- Corporation retains existing basis in its assets.
- Subsequent distributions of property may trigger gain inside corporation. If S Corporation, gain passes through to shareholder.
- Trap for the unwary:
  - Could need to trigger loss on corporation stock in same year as inside gain; and
  - Redemption or liquidation.
- Pre-death alternative:
  - Sell S Corporation assets to a partnership in exchange for a note; and
  - Partnership assets enjoy more straightforward step-up in basis.

Death of S Corporation Shareholder

- Scenario:
  - Immediately before her death, Susan owns 100% of S Corporation stock with a basis of $100;
  - Thomas, her son, inherits the stock;
  - The S Corporation owns a capital asset with a basis of $100 and a FMV of $1,000; and
  - The S Corporation distributes the asset to Thomas.
- Consequences:
  - Thomas starts with FMV basis of $1,000 in the stock.
  - By distributing an appreciated asset, the S Corporation triggers gain of $900.
  - The gain of $900 is passed through to Thomas.
  - Thomas increases his basis in S Corporation stock to $1,900.
  - Thomas reduces his basis in the S Corporation stock by the $1,000 FMV of the distributed asset.
  - Thomas owns stock with basis of $900 and FMV of $0.
  - Typically, Thomas wants to trigger the loss on the stock in that same year.
  - Similar results if a C Corporation.

IRC Section 303 – Redemption to Pay Estate Tax

- IRC § 303 allows a corporation to make a distribution in redemption of a portion of the stock of a decedent that will not be taxed as a dividend.
  - This permits a decedent shareholder’s executor to pay death taxes and other expenses.
- Attribution rules do not apply.
- Any excess:
  - Will be taxed under IRC § 302 rules as a dividend to the seller (executor or heir from whom stock is being redeemed); or
  - May qualify for favorable tax treatment under IRC § 302 (no taxable gain due to step-up in basis at decedent’s death).
- The redeemed stock must be included in the decedent’s gross estate for federal estate tax purposes
- The value for federal estate tax purposes of all stock of the corporation that is included in determining the value of the decedent’s gross estate must be more than 35% of the excess of:
  - The value of the gross estate less the sum allowable as a deduction under Section 2053 (estate expense, indebtedness, and taxes) and Section 2054 (losses).
- Section 303 Redemption amount is limited to the total of:
  - All estate, inheritance, legacy and succession taxes (including GST taxes) and interest imposed thereon by reason of decedent’s death.
  - Funeral and administration expenses (whether or not claimed as a deduction on the federal estate tax return).
- Applies to both C Corporations and S Corporations, but more relevant to C Corporations.

QSST and ESBT Election

QSST v. ESBT

- Only a trust that is i) a Qualified Subchapter S Trust ("QSST") or ii) an Electing Small Business Trust ("ESBT") can be a shareholder of an S Corporation.
- Disadvantages of QSSTs include:
  - Can be only one lifetime beneficiary of a QSST;
  - All the ordinary income of a QSST must be distributed to the beneficiary currently, regardless of need, no ability to accumulate income;
  - Minor, spendthrift, or special-needs QSST beneficiary have full access to QSST income; and
  - QSST's share of the S Corporation's distributed income to potential claims and lawsuits against the QSST's beneficiary.
- Disadvantages of ESBTs include:
  - Under IRC § 678, it may be impossible in certain situations to cause all the taxable income allocable to an ESBT's interest in the S Corporation to be taxed to the trust's beneficiaries; and
  - If a portion of the taxable income of the S Corporation is not distributed to the ESBT, the ESBT will be charged at the highest federal income tax rate.

Shareholder Type: Qualified Subchapter S Trusts (QSSTs)

- Requirements (IRC § 1361(d)(3)):
  - During the life of the current income beneficiary, there can be only one income beneficiary of the trust;
  - Any distributions of principal during the life of the current income beneficiary may be distributed only to that income beneficiary;
  - The current income beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust;
  - Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary; and
  - The trust’s accounting income must either:
    - Actually be distributed to the income beneficiary at least annually; or
    - Be required by the trust instrument to be distributed at least annually.

Shareholder Type: Electing Small Business Trusts (ESBTs)

- Unlike QSSTs, Electing Small Business Trusts may have multiple beneficiaries and may accumulate trust income.
- To elect ESBT status, a trust must (IRC § 1361(e)):
  - Be a domestic trust;
  - Have only individuals, estates, or certain charitable organizations as beneficiaries;
  - Have no beneficiaries who acquired their interest by purchase; and
  - Have its trustee make a timely election.
- An ESBT cannot be an exempt trust, a charitable remainder trust or a QSST with respect to another corporation.

Shareholder Type: Electing Small Business Trusts (ESBTs)

- For tax purposes, an ESBT is treated as two separate share trusts:
  - an S portion that consists of S Corporation stock; and
  - a non-S portion that consists of all other trust assets.
- An ESBT that is a partial grantor trust can have three portions:
  - the grantor portion;
  - a non-grantor S portion; and
  - a non-grantor non-S portion.
- Only the S portion of the trust is treated as the shareholder for taxable income, basis, and distributions purposes.

Death of S Corporation Shareholder

- The death of shareholder creates a potential of inadvertently terminating the S Election.
- Corporate governance documents, including buy-sell agreements should include provisions requiring a successor shareholder to be a qualifying shareholder.
- Steps should be taken to ensure that the successor shareholder is a qualifying shareholder.
- Determine if an election is required and if so when:
  - If the shares are transferred to another trust immediately, an election might be due within 2½ months of that transfer. IRC § 1361(e)(3) and Treas. Regs. § § 1.1361-1(j)(6) and 1.1361-1(m)(2).
  - For example, an estate may own S corporation stock during a reasonable period of administration. Testamentary trusts (those created in a will) may own S corporation interests for two (2) years from receipt of the stock from the estate. Former grantor trusts whose grantor-trust status terminated by reason of the grantor's death may own S corporation stock for two (2) years from date of death.

QSST and ESBT Election

- If the S Corporation transfers its stock to the QSST on or before the date the corporation makes its S election, the QSST election may be made on Part III of Form 2553.
- After the initial S election, QSST beneficiary must make the QSST election under Sec. 1361(d)(2), by filing a statement with the information and in the manner prescribed by Treas. Regs. Sec. 1.1361-1(j)(6) and Rev. Proc. 2013-30.
- The ESBT trustee makes the election by completing and filing the election statement described in Regs. Sec. 1.1361-1(m)(2).
- Both the QSST and ESBT election must be made within a two-month-and-16-day period beginning on the date of the trust's receipt of the S Corporation stock (see Regs. Secs. 1.1361-1(m)(2)(iii) and (j)(6)(iii)).

S Corporation Relief

- Rev. Proc. 2013-30
  - Late QSST or ESBT election.
  - Less than 3 years and 75 days have passed since the intended effective date of the election.

- Rev. Proc. 2004-35:
  - Missing shareholder consent due to community property.

- Private letter rulings and IRC § 1362(f)
  - Inadvertent ineffective elections or insufficient shareholder consents.

Intentionally Defective Grantor Trusts

Intentionally Defective Grantor Trust (“IDGT” or “IDIT”)

- An IDGT seeks to take advantage of the differences between the estate tax inclusion rules of IRC § § 2036-2042 and the grantor trust income tax rules of IRC § § 671-678.
- An IDGT is an irrevocable trust that effectively removes assets from the grantor’s gross estate.
- For income tax purposes, however, the trust is “defective”, and the grantor is taxed on the trust’s income.
- The IDGT’s income and appreciation accumulates inside the trust gift and GST tax free.

Intentionally Defective Grantor Trust ("IDGT" or "IDIT")

In order to be defective, trustor or a "power holder" must retain a grantor trust power, the most common powers utilized include:

- Substitution. The trust includes a power exercisable by the grantor (in a non fiduciary capacity) to reacquire trust assets by substituting assets of equivalent value. IRC § 675(4)(C).
- Additional Beneficiary. The trust includes a power held by a non-adverse party to add to the class of beneficiaries (other than the grantor's after-born or after-adopted children). IRC § 674(a). Often this power is limited to additional charitable beneficiaries.
- Power to Loan. The trust includes a power to enable the trustee to loan money or assets to the grantor from the trust without adequate security. IRC § 675(2).

Sale to IDGT

Benefits of installment sale to an IDGT works:

- No capital gains tax on sale. Rev. Rul. 85-13.
- Arbitrage. Freezes value of appreciation on assets sold at the AFR.
- Interest payments not taxable to grantor.
- Payment of IDGT's income taxes by grantor leaves more assets in the IDGT – gift tax free. Rev. Rul. 2004-64.
- Valuation discounts increase effectiveness of technique.
- IDGT is an eligible Subchapter S shareholder during grantors life.
- Can be used with a sale of an interest in a QOF.

Swapping Assets with Existing IDGTs

Many intentionally defective grantor trusts ("IDGTs") include the power to swap assets between the IDGT and the grantor.

- Retained Power. A common power used to achieve grantor trust status for the IDGT is retaining in the grantor or powerholder the right to reacquire the trust corpus by substituting other property of an equivalent value (Code § 675(4)(c)).
- Income Tax Transactions. For income tax purposes, transactions between the grantor and the IDGT are disregarded. As such, the powerholder may swap high basis assets for low basis assets without jeopardizing the estate tax inclusion of the assets and without having a taxable transaction for income tax purposes.
- Stepped Up Basis. After formation, low basis assets can be swapped and moved into the taxable estate of the Grantor to achieve a step up.

Opportunity Zone Funds and Estate Planning

Overview of QOZ Program

- The Tax Reform Reconciliation Act of 2017 enacted the QOZ Program as IRC § § 1400Z-1 and 1400Z-2.
- Notice 2018-48 identifies the Opportunity Zones in the United States.
- Temporary tax deferral for all capital gains reinvested in an Opportunity Zone Fund, lasting until the investment is sold, December 31, 2026, or a gain “inclusion event,” whichever is soonest.
- A taxpayer who defers gains through a Qualified Opportunity Fund (QOF) investment receives a 10% step-up in tax basis after five years and an additional 5% step-up after seven years.
  - To be eligible for the 10% step-up in tax basis, the taxpayer needed to invest by December 31, 2021 and to invest by December 31, 2019 for the additional 5% step-up in tax basis.
- If a taxpayer holds the Opportunity Fund investment for 10+ years, taxpayer receives a stepped-up basis to fair market value at that time.

Tax Benefits of QOZ

Deferral of gain

- A taxpayer can elect to exclude capital gain to the extent he makes a qualified investment in a QOF
  - Applies to STCG, LTCG, capital gain dividends, and net 1231 gain
  - Does not apply to gain on sales to related persons or from offsetting positions
  - For a pass through entity, the election can be made by the entity, or to the extent not made by the entity, by an owner with respect to his portion of the remaining gain
  - Election is made on Form 8949 (Sales and Other Dispositions of Capital Assets)
- Election must be made within 180 days after the recognition date
  - For net 1231 gain, the 180 day period begins at the end of the tax year.
  - For election by an owner of a pass through entity, the 180 day period begins on date for the entity election or the last day of entity's tax year.

Inclusion of deferred gain

- The excluded gain must be included in income on the earlier of the date of an inclusion event or December 31, 2026
  - On an inclusion event: include the lesser of the percentage of the deferred gain attributable to the qualified investment disposed of or the FMV of the qualified investment disposed of

QOZ Inclusion Events

Inclusion events include:

- Reduction in qualified investment, including a gift (except as a result of the taxpayer’s death, but the deferred gain is IRD)
- Certain distributions by a QOF (except for a partnership, distributions not in excess of the partner’s outside basis provided it is not part of a disguised sale)
- Claim of worthlessness deduction
- QOF ceases to exist
- Liquidation of QOF owner
- Change in status of grantor trust (except as a result of the grantor’s death)
- Does not include certain tax-free asset transfers

QOZF and Death

The final regulations state, as a general rule, that "a transfer of a qualifying investment by reason of the taxpayer's death is not an inclusion event" [Treasury Regulations section 1.1400Z2(b)-1(c)(4)(i)], and provides the following examples:

- A transfer by reason of death to the deceased owner's estate.
- A distribution of a qualifying investment by the deceased owner's estate.
- A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death.
- The passing of a jointly owned qualifying investment to the surviving co-owner by operation of law.
- Any other transfer of a qualifying investment at death by operation of law.

The final regulations clarify that the following are inclusion events and the IRD rules apply:

- A sale, exchange or other disposition by the deceased taxpayer's estate or trust, other than a distribution described above.
- Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death.
- Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death.
- Of particular relevance, section 1400Z-2(b)(2) contains a special rule that caps the amount of the gain so as not to exceed the fair market value of the investment as of the date that the gain is included in income.

QOZ Investment Held by a Pass-Through Entity

- Final regulations contain a special rule for determining the amount includible for partnerships and S corporations. Treasury Regulations section 1.1400Z2(b)-1(e)(4) provides that, in the case of an inclusion event involving a qualifying investment in a QOF partnership or S corporation, or in the case of a qualifying investment in a QOF partnership or S corporation held on Dec. 31, 2026, the amount of gain included in gross income is equal to the lesser of:

    1) the product of the percentage of the qualifying investment that gave rise to the inclusion event and the remaining deferred gain, less any basis adjustments pursuant to section 1400Z-2(b)(2)(B)(iii) and (iv), or

    2) the gain that would be recognized on a fully taxable disposition at fair market value of the qualifying investment that gave rise to the inclusion event.

- Important to incorporate stepped-basis rules applicable to partnerships and S Corporation to avoid phantom income.

Sale of Interest in QOF to an IDGT

- Gifts and sales and exchanges are generally inclusion events.
- The final regulations continue to provide an exception to this general rule in the case of grantor trusts.
- Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i) clarifies that a sale of an interest in a QOF to an IDGT, as described in Rev. Rul. 85-13 is not an inclusion event.
- For larger estates, this exception creates an opportunity to move the value of appreciating assets outside of the taxable estate, while being able to benefit from a step-up in basis.
- The step-up in basis is in year 10 rather than at the date of the decedent's death.

Comparison with Like-Kind Exchange

An Investment in QOZ is often compared and can be an alternative to a IRC § 1031 exchange.

	QOZ	IRC § 1031
Relinquished property	Capital gain or net 1231 gain	U.S. real property
Replacement property	Equity in QOF	Like-kind U.S. real property
Who can reinvest	The seller, or if a pass through entity, any owner allocated gain	The seller
Reinvestment required to defer total gain	Amount of gain	Total proceeds must also match any mortgage
Time to reinvest	180 days	The earlier of 180 days or the due date of the tax return (including extensions), but must designate within 45 days
Ability to receive cash	Yes	No
Basis in replacement property	-0-, but is increased by gain eliminated and recognized; FMV on sale after 10 years	Carryover basis
Step up at death	No	Yes

Section 1031 Like-Kind Exchange and Estate Planning

- A taxpayer and their heirs/beneficiaries can benefit greatly from a 1031 Exchange when selling business or investment use real estate.
- To obtain the benefit of IRC § 1031 in estate planning, inclusion in the decedent’s taxable estate is required.
- Step-up in basis allows beneficiaries not only to sell with increased basis and therefore less gain, but also to be able to depreciate the real estate using the new stepped up basis.
- No tax due at the time of selling the property, which allows for maximum reinvestment.
- IRC § 1031 applies to both:
  - Active investments such as single- or multi-family rentals, commercial or industrial properties
  - Passive investments such as raw land, or Delaware Statutory Trust fractional ownership properties