Qualified Opportunity Funds: A new weapon in the estate planning arsenal

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The Tax Cuts and Jobs Act created a new program to encourage investment in economically distressed areas through generous tax incentives. The Qualified Opportunity Zone program relies on investments in Qualified Opportunity Funds ("QOFs") — funds that can provide wealthy taxpayers with some new avenues for estate planning.

3 big tax benefits

Investors in QOFs stand to reap three significant tax breaks:

1. They can defer capital gains on the disposition of appreciated property by reinvesting the gains in a QOF within 180 days of disposition. The tax is deferred until the QOF investment is sold or Dec. 31, 2026, whichever is earlier.
2. Depending on how long they hold their QOF investment, they can eliminate 10% to 15% of the tax.
3. After 10 years, post-acquisition appreciation on the investment is tax-exempt.

By incorporating QOFs in your estate planning, you can reduce both capital gains and transfer tax liabilities.

Estate planning implications

Proposed regulations make clear that a QOF investor's death isn't an "inclusion event" that would trigger tax on the deferred gains. In addition, most of the activities involved in administering an estate or trust (for example, transferring the interest to the estate or distributing the interest) won't trigger the gain. But the sale of the QOF interest by the estate, the trust or a beneficiary would. Gifts of QOF interests also are generally considered inclusion events that make the deferred gains immediately taxable.

You could avoid this, though, by gifting your QOF interest to a trust treated as a grantor trust for income tax purposes under the rules of Sections 671 through 679 of the Internal Revenue Code. Both revocable living trusts and irrevocable grantor trusts qualify. However, transfers to the latter are completed gifts and therefore produce greater potential tax savings in situations where the income and gains of the trust are taxed to the grantor, in turn reducing the grantor's estate by the amount of income taxes paid. (Note, though, that the termination of grantor trust status for reasons other than the grantor's death is treated as an inclusion event.)

For example, you could transfer a highly appreciated asset to an irrevocable trust with no gift tax under the federal gift and estate tax exemption ($11.40 million for 2019 and $11.58 million for 2020). The trust could sell the asset and defer the gains into a QOF investment.

Another option for transferring QOF interests is the grantor retained annuity trust, which allows you to make a gift to a trust and receive an annuity interest roughly equal to the fair market value of the gift. Any appreciation beyond the amount required to pay the annuity also passes to the beneficiaries without gift tax.

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