Chicago Estate Planning Council

Thursday, December 12, 2019

Qualified Opportunity Zones: What Estate Planners Need to Know[1]

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1 These materials were initially prepared for the telephone seminar and audio webcast of "Qualified Opportunity Funds and Opportunity Zones: What Estate Planners Need to Know" by The American Law Institute Continuing Legal Education (ALI-CLE) and co-sponsored by The American College of Trust and Estate Counsel (ACTEC). They are reprinted here with the permission of the ALI-CLE, ACTEC and the authors of the materials, Kevin Matz, Farhad Aghdami, Todd Angkatavanich, and Benetta Jenson (now known as Benetta Y. Park).

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Qualified Opportunity Funds and Opportunity Zones:

What Estate Planners Need to Know

ACTEC / ALI-CLE Webinar

May 30, 2019

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Overview

- The 2017 Tax Cuts and Jobs Act includes a new tax incentive provision that is intended to promote investment in economically-distressed communities, referred to as “Opportunity Zones.” Through this program, investors can achieve the following three significant tax benefits:

1. The deferral of gain on the disposition of property to an unrelated person until the earlier of the date on which the subsequent investment is sold or exchanged, or December 31, 2026, so long as the gain is reinvested in a “Qualified Opportunity Fund” within 180 days of the property’s disposition;

2. The elimination of up to 15% of the gain that has been reinvested in a “Qualified Opportunity Fund” provided that certain holding period requirements are met; and

3. The potential elimination of tax on gains associated with the appreciation in the value of a Qualified Opportunity Fund, provided that the investment in the Qualified Opportunity Fund is held for at least ten years.

Opportunity Zones

- An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.
- Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Internal Revenue Service (IRS).
- All Opportunity Zones have now been designated, as of June 14, 2018, and are available on the U.S. Department of Treasury website. *See* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

Qualified Opportunity Funds

- A Qualified Opportunity Fund, in turn, is an investment vehicle that is established as either a domestic partnership or a domestic corporation for the purpose of investing in eligible property that is located in an Opportunity Zone and uses investor gains from prior investments as a funding mechanism.
- The investor can get the tax benefits of Opportunity Zones even if the investor doesn’t live, work or maintain a business in an Opportunity Zone – the investor just needs to invest in a Qualified Opportunity Fund.

Qualified Opportunity Funds

- To become a Qualified Opportunity Fund, the entity self-certifies itself by attaching Form 8996 to the entity’s timely filed federal income tax return for the taxable year taking into account extensions
- The entity must meet certain requirements, in particular a general requirement that at least 90% of its assets be “qualified opportunity zone property” used within an Opportunity Zone (as further discussed below), but no approval or action by the IRS is required.

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- To qualify for these tax benefits, the investor’s reinvestment in the Qualified Opportunity Fund must occur during the 180-day period beginning on the date of the sale.
  - The Proposed Regulations provide some relief in the case of certain pass-through entities.
- Under IRC section 1400Z-2(a)(2), the taxpayer may elect to defer the tax on some or all of that gain.
- If, during the 180-day period, the taxpayer invests in one or more Qualified Opportunity Funds an amount that was less than the taxpayer’s entire gain, the taxpayer may still elect to defer paying tax on the portion of the gain invested in the Qualified Opportunity Fund.
- If, in contrast, an amount in excess of the taxpayer’s gain is transferred to the fund (a so-called “investment with mixed funds”), the taxpayer is treated, for tax purposes, as having made two separate investments -- one that only includes amounts as to which the investor’s deferral election is made, and a separate investment consisting of other amounts.

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- Importantly, the law requires only that the ***gain*** be reinvested in the Qualified Opportunity Fund, and not the total sales proceeds.
  - ➢ The Proposed Regulations have clarified that, in general, only capital gains are eligible to be invested in a Qualified Opportunity Fund
- In addition, in contrast to Section 1031 “like-kind” exchanges (another mechanism of gain deferral through reinvestment), in the Qualified Opportunity Funds context the cash from the sale does not need to be specifically tracked or escrowed.
- Instead, the requirement is merely that an amount of cash equal to the gain on the sale be reinvested in a Qualified Opportunity Fund within 180 days of the property’s disposition (subject to potential relief in the case of certain pass-through entities).

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- The taxpayer’s basis in the Qualified Opportunity Fund is initially zero, but will be increased by 10% of the deferred gain if the investment in the Qualified Opportunity Fund is held for 5 years, and increased by an additional 5% (to 15% of the deferred gain in total) if the investment in the Qualified Opportunity Fund is held for 7 years.
- Thus, if a gain on the sale of property is timely reinvested in a Qualified Opportunity Fund, the taxpayer may be able to decrease the taxable portion of the originally deferred gain by 15% (via a corresponding basis step-up) if the investment in the Qualified Opportunity Fund is held for at least 7 years.
- The taxpayer makes an election to defer the gain, in whole or in part, when filing the tax return on which the tax on that gain would otherwise be due if it were not deferred.

Exclusion of Gain on Appreciation in the Value of QOF if Held for At Least 10 Years

- The tax incentives of this program go well beyond tax deferral (even putting aside the potential basis adjustments discussed above), as subsequent gain on the appreciation in the value of the Qualified Opportunity Fund is capable of being ***fully excluded from income***.
- In order to qualify, the investor must hold its reinvestment in the Qualified Opportunity Fund for at least 10 years.

QOF Requirements

- An entity must meet certain requirements to qualify as a QOF.
- Specifically, a QOF must meet a test (the “90% Asset Test”) whereby 90% of its assets, measured every 6 months and averaged for each year, must be qualifying “QOZ Property.”
- To meet this requirement, a QOF may (i) directly own “QOZ Business Property” or (ii) may own a QOZ Business that in turn owns QOZ Business Property.
- A QOF may not, however, own (as a qualifying asset) an interest in another QOF.
- A QOZ Business must (i) have “substantially all” of its tangible assets invested in QOZ Business Property, (ii) meet certain requirements under Section 1397C regarding permissible assets (including a general prohibition against owning more than 5% nonqualified financial assets such as cash), and (iii) comport with certain “sin business” prohibitions under section 144(c)(6)(B).

QOF Requirements

- **QOZ Business Property** means, in general, **tangible property acquired by purchase from an unrelated party**, which property either is "**originally used**" in the QOZ by the QOF or QOZ Business, **or** is "**substantially improved**" by the QOF or QOZ Business (meaning, generally, improvements over a period of 30 months that result in a 100% increase to the adjusted basis of the property).
- Section 1397C generally governs the rules applicable to tax credits for so-called "enterprise zone businesses."
    - Several of these provisions – section 1397C(b)(2), (b)(4) and (b)(8) – are incorporated into the QOZ rules by reference.
- "Relatedness" for this purpose is generally determined by a 20% or greater common ownership test taking into account certain constructive ownership rules.

Effect of Death

- Section 1400Z-2(e)(3) provides that, “[i]n the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691.”
- This statutory provision raises questions concerning the appropriate treatment of the deferred gain where a person who has rolled over gain through a timely investment in a QOF dies prior to December 31, 2026 without having previously disposed of the QOF investment.
- Section 691 sets forth the rules that apply to a person’s receipt of income in respect of a decedent (“IRD”).
    - ➢ IRD refers to income earned by a decedent who was a cash basis taxpayer prior to his or her death, but that is not properly includible in income until after the decedent’s death. IRD is not reportable on the decedent's final income tax return.
    - ➢ Rather, it is reportable by the recipient of the IRD item (e.g., by the decedent’s estate or some other person).

Special Rule that Caps Gain at Fair Market Value at Date of Triggering Event

- 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. It provides as follows:

- **1400Z-2(b)(2) AMOUNT INCLUDIBLE.—**
- **1400Z-2(b)(2)(A) IN GENERAL.—** The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of—
- **1400Z-2(b)(2)(A)(i)** the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over
- **1400Z-2(b)(2)(A)(ii)** the taxpayer’s basis in the investment.

The 1st Round of Proposed Regulations

- On October 19, 2018, the Internal Revenue Service released the first set of proposed regulations (the "Proposed Regulations") and Revenue Ruling 2018-29 (the "Revenue Ruling") clarifying certain aspects of the Qualified Opportunity Zone ("QOZ") provisions added by the tax reform legislation enacted in December 2017.
- The IRS indicated that it expected to issue additional guidance before the end of 2018 (which did not happen), and the IRS requested comments on a number of provisions in the Proposed Regulations.
- The Proposed Regulations state that they may apply to transactions occurring before the finalization of such regulations, provided they are applied consistently.

The 1st Round of Proposed Regulations

Only Capital Gains Eligible for Reinvestment

- The Proposed Regulations provide that only capital gains may be “rolled over” into a QOZ investment.
  - ➢ This would preclude ordinary income from the sale of inventory (and possibly would preclude gain recharacterized as ordinary income under certain “recapture” rules).

The 1st Round of Proposed Regulations

Partners in Pass-Through Entities May Reinvest Share of Entity's Gains from Asset Sales

- The Proposed Regulations include special provisions by which gain recognized by a partnership may (except to the extent the partnership elects to rollover the gain itself) flow through to the partners and be reinvested by such partners into qualified opportunity funds ("QOFs").
  - ➢ It was previously unclear whether the partner or the partnership had to make such reinvestment.

The 1st Round of Proposed Regulations

Partners in Pass-Through Entities May Reinvest Share of Entity's Gains From Asset Sales (cont'd)

- In addition, there is the potential for such partners to have an increased period during which to reinvest gain into a QOF.
- The partnership's 180-day period begins on the date of its sale, but if the gain flows through to the partners, the partners' 180-day period begins on the last day of the partnership's taxable year.
- Partners may instead elect to use the partnership's 180-day period if they so desire (e.g., if the desired investment is already lined up).

The 1st Round of Proposed Regulations

QOFs Always Tested at End of Calendar Year

- The Proposed Regulations clarify that, while the initial testing date for a QOF (for purposes of the 90% asset test, discussed below) may be as long as six months after the QOF's start date, there is *always* a testing date on the last day of the calendar year.
  - Accordingly, QOFs that are formed near the end of a calendar year may need to meet the 90% asset test sooner than expected.
- The Proposed Regulations do, however, provide flexibility for QOFs to select the date on which they begin to qualify (although QOFs must qualify as such prior to receiving investments for such investments to qualify under the QOZ provisions), and for taxpayers to use pre-existing entities as QOFs.

The 1st Round of Proposed Regulations

LLCs Likely Permitted

- The Proposed Regulations state that QOFs may include entities treated as partnerships for federal income tax purposes, which would presumably permit the use of limited liability companies.

Investors May Hold Investments Past Expiration of QOZ Designation

- Although the statute provides that the QOZ designations expire after 10 years, the Proposed Regulations permit investors seeking to take advantage of the 10-year rule to hold their investments for an additional 20-year period — until December 31, 2047 — and still receive the benefit of the exclusion from income of all post-acquisition appreciation.

The 1st Round of Proposed Regulations

Treatment of Land

- The Proposed Regulations and Revenue Ruling provide that land is treated separately from the improvements thereon for purposes of the substantial improvement test, and provide several important clarifications regarding the treatment of land.

- The Revenue Ruling provides that land, given its permanence, may *never* be treated as originally used by a QOF in a QOZ.
    - ➢ However, the examples in the Revenue Ruling indicate that the land may qualify as QOZ Business Property if the improvements thereon qualify, even if such land is not improved.
    - ➢ Accordingly, for the substantial improvement test, a QOF need only substantially improve the *building* on a parcel of acquired land in order for the entire parcel to qualify for the 90% asset test.

The 1st Round of Proposed Regulations

Treatment of Land (cont'd)

- In addition, the example in the Revenue Ruling involves the conversion of a factory building into residential rental property.
  - As the building was already in existence and is being modified (rather than a new one being constructed), it must meet the substantial improvement test rather than the original use test.
  - The example also seems to confirm that residential rental property does indeed qualify as potential QOZ property.

The 1st Round of Proposed Regulations

QOZ Business "Substantially All" Requirement to Mean at Least 70%

- QOFs may own QOZ businesses (rather than directly owning qualified opportunity zone property), with the requirement that a QOZ business have "substantially all" of its assets be qualified opportunity zone property.
- The Proposed Regulations provide that, solely for this purpose, "substantially all" means at least 70%.
- Accordingly, a QOF that owns a QOZ business may have as little as 63% of its capital invested in qualified opportunity zone property (90% in the QOZ business, per the 90% asset test, times 70% of the business's property).
- This may provide additional flexibility as to the timing of capital investments into a QOF and the use of such capital.

The 1st Round of Proposed Regulations

Working Capital Safe Harbor

- The Proposed Regulations provide certain safe harbors relating to working capital and asset composition of a QOF to the extent that such assets are held in QOZ businesses.
- Specifically, the “reasonable working capital” safe harbor of Section 1397C(e)(1) of the Internal Revenue Code now also extends to QOZ businesses for a period of 31 months.
- Thus, a QOZ business can have as long as 31 months to deploy working capital provided that the documentation requirements contained in the Proposed Regulations are satisfied.

The 1st Round of Proposed Regulations

Working Capital Safe Harbor (cont'd)

- The IRS's instructions to the Form 8996 describe these documentation requirements in terms of the following four-part test that must be satisfied:
  - (1) The working capital is designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone.
  - (2) There is a reasonable written schedule for the expeditious consumption of the working capital to achieve the goal set out in (1) above.
  - (3) The working capital will be completely consumed no later than 31 months after the amounts are first invested in eligible interests in the relevant QOF.
  - (4) The working capital is consumed in a manner that is substantially consistent with the requirements in items (1) through (3).

The 1st Round of Proposed Regulations

Working Capital Safe Harbor (cont'd)

- Additional helpful clarification on the working capital safe harbor was provided in Treasury's second tranche of proposed regulations that was released in April 2019.
- The new proposed regulations give additional flexibility to the working capital safe harbor, including by allowing the written working capital schedule to provide for expenditures for broader costs of business operation, rather than only for the acquisition of qualifying QOZ business property.
- This safe harbor also will not be violated in the 31-month period is exceeded due to delays in receiving governmental approvals.

The 1st Round of Proposed Regulations

Comment Letters

- A number of organizations including the American College of Trust and Estate Counsel (ACTEC) submitted comment letters to address open points in the legislation and the 1st Round of Proposed Regulations.
    - ACTEC's comments may be found at this link:

  https://www.actec.org/assets/1/6/ACTEC-comments-to-Treasury-re-Qualified-Opportunity-Funds-2018-12-27.pdf

ACTEC's Comments to the 1st Round of Proposed Regulations

- ACTEC's comments to the 1st round of proposed regulations addressed 4 key points:
  - 1. A request for clarification concerning the income tax consequences resulting from the death of a taxpayer who has deferred gain through a timely reinvestment of gain in a QOF, including a request to provide relief for successors-in-interest
    - *The concern here is that the estate beneficiary or other successor-in-interest of the QOF interest may not have the liquidity necessary to pay the deferred tax that becomes due at that time.*
    - *This could be particularly problematic if the fund does not contain redemption provisions, or if a secondary market for the interest in the fund has not matured.*
    - *Does tacking of the holding period apply in the case of death?*

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 2. A request for clarification concerning the income tax consequences resulting from the gift of an interest in a QOF where the donor has deferred gain through a timely reinvestment of gain in a QOF

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 3. A request for clarification concerning grantor trusts, including to confirm that a transaction with a grantor trust that is disregarded for income tax purposes pursuant to Rev. Rul. 85-13 should not be considered a sale or exchange of an interest in a QOF
  - *Clarification was requested that it should not matter whether the gain that is sought to be deferred, or the funds that are subsequently invested in the QOF, belong to the taxpayer or the taxpayer's grantor trust*
  - *Does tacking of the holding period apply in the case of transactions with grantor trusts?*

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 4. A request to provide relief to extend the 180-day period for rollover of gain to a QOF to partners, S corporation shareholders and beneficiaries of estates and trusts because they may not receive a Schedule K-1 indicating capital gains until more than 180 days after the end of the taxable year
  - *ACTEC proposed that the time to rollover the gain be the later of (i) 180 days after the end of the relevant tax year (which is the current rule under the proposed regulations) and (ii) 180 days after the timely filing (taking into account extensions) of the tax return for the partnership, S corporation, estate or trust that has incurred such gain*

The Second Round of Proposed Regulations

- On April 17, 2019, Treasury released its second round of proposed regulations on QOFs.
- The due date for the submission of Comments to Treasury on these proposed regulations is July 1, 2019.

Estate Planning with QOZs

Farhad Aghdami

WILLIAMS MULLEN

Inclusion of Deferred Gains

- Second Set of Proposed Regulations Issued April 17, 2019
- General Rule on Transfers
  - Any disposition of the owner's qualifying investment is an inclusion event
  - A taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF
  - A taxpayer claims worthlessness deduction with respect to its qualifying investment.
    - Treas. Reg. § 1.1400Z2(b)-1(c)(1)

Estate Planning Related Transfers

> Transfer of Qualifying Investment by Gift

- A taxpayer's transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event, <u>regardless</u> of whether that transfer is a <u>completed</u> gift for Federal gift tax purposes, and regardless of the <u>taxable</u> or <u>tax-exempt</u> status of the donee of the gift.
  - Treas. Reg. § 1.1400Z2(b)-1(c)(3)

> Charitable Contributions

- The Preamble to the Regulations confirms that a charitable contribution of a qualifying interest is also an inclusion event because the owner's qualifying investment is terminated upon the transfer.

> Grantor Trusts

- If the owner of a qualifying investment *__contributes__* it to a grantor trust, the owner of the investment is the deemed owner of the trust, the *__contribution__* is not an inclusion event. (Emphasis added)
  - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i)
  - The rationale for this exception is that the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust.

Estate Planning Related Transfers

> Grantor Trusts

- However, any change in the grantor trust status of the trust (except by reason of the grantor's death) is an inclusion event because the owner of the trust property for Federal income tax purposes is changing.
  - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii)
- Favorably, neither the termination of grantor trust status by reason of the grantor's death, nor the distribution by that trust to a trust beneficiary by reason of the grantor's death is an inclusion event.

Estate Planning Related Transfers

> Death

- Most transfers by reason of death will terminate the owner's qualifying investment.
- For example, the qualifying investment may be distributed to a beneficiary of the owner's estate or may pass by operation of law to a named beneficiary. In each case, the owner's qualifying investment is terminated.
- Distribution of the qualifying investment to the beneficiary by the estate or by operation of law is not an inclusion event.
  - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii)

Transfers By Reason of Death

> Transfers By Reason of Death Include the Following:

- 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; and
- Any other transfer of a qualifying investment at death by operation of law.
- Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)

WILLIAMS MULLEN finding yes®

Transfers By Reason of Death

> Transfers By Reason of Death Excludes the Following:
  - A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than an excluded distribution described in paragraph (c)(4)(i)
  - 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
  - Treas. Reg. § 1.1400Z2(b)-1(c)(4)(ii)

Estate Planning Related Transfers

> Inclusion Event
  – The gain to which a deferral election applies is included in gross income in the taxable year that includes the earlier of (1) the date of the inclusion event or (2) December 31, 2026

> Income in Respect of a Decedent
  – In each estate planning related transfer where there is no inclusion event in connection with the transfer, the <u>transferee</u> of the qualifying investment has the obligation under Code Section 691 to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient.

Basis

- > No Basis Adjustment Under Code § 1014 at Death If No Inclusion Event
- > Deferred Gain Carried Over to Estate/Transferee
- > QOZ Fund Interest Generates Income in Respect of a Decedent (IRD)
  - – Basis in the QOZ Fund Interest will not be stepped-up to the extent of the IRD

Holding Period

- If gift is not considered an inclusion event, the holding period of a qualifying investment is "tacked" and includes the time during which a qualifying investment that was held by the donor
- In the case of death, the holding period of a qualifying investment is "tacked" and includes the time during which that qualifying investment was held by the deceased owner.
- In each case where there is tacking, the transferee steps into the shoes of the transferor with respect to the five-year, seven-year, and 10-year holding periods

Planning Opportunities

Planning Opportunities

> Eleanor Entrepreneur sells her Artificial Intelligence business for $100 million in June 2019
  - Gain That She Reinvests in QOZ Fund is Deferred Until 2026
  - As a Serial Investor Entrepreneur, She Can Reinvest Proceeds Into New Businesses Located in an Opportunity Zone
  - Avoid Gain on Sale of New Investment

Planning Opportunities

- Oscar Oldmoney has a large concentration of very low basis tobacco stocks that have been in his family for many years.
  - He is concerned that "vaping" and legalized marijuana will be a disruptive force and wants to diversify out of the tobacco stocks, but wants to minimize the resulting gain
  - Oscar can sell the tobacco stocks and defer gain until 2026 and reinvest in QOZ Fund assets
  - If Oscar dies before 2026, unreported gain is income in respect of a decedent and Oscar's heirs must pay tax at that time

Planning Opportunities

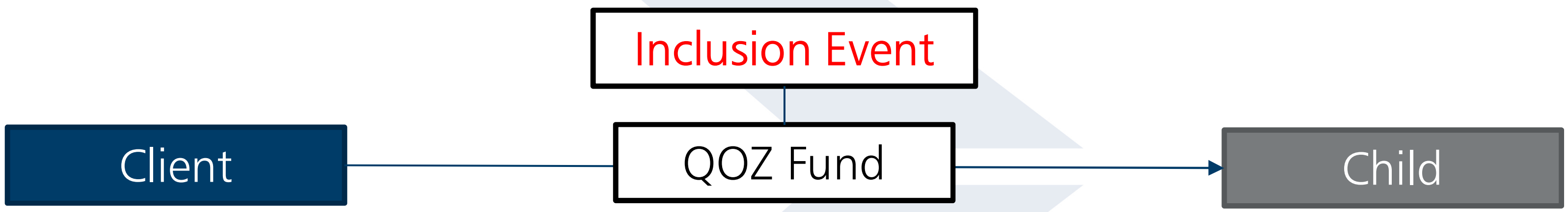
> Fred Fiduciary is the Trustee of a Dynasty Trust with concentrated stock positions with very low basis

- Fred can sell the stocks and defer gain until 2026 and reinvest in QOZ Fund assets, thereby diversifying the trust portfolio
- New investment in QOZ Fund not subject to capital gain tax

Planning Examples and Open Issues in the Regulations

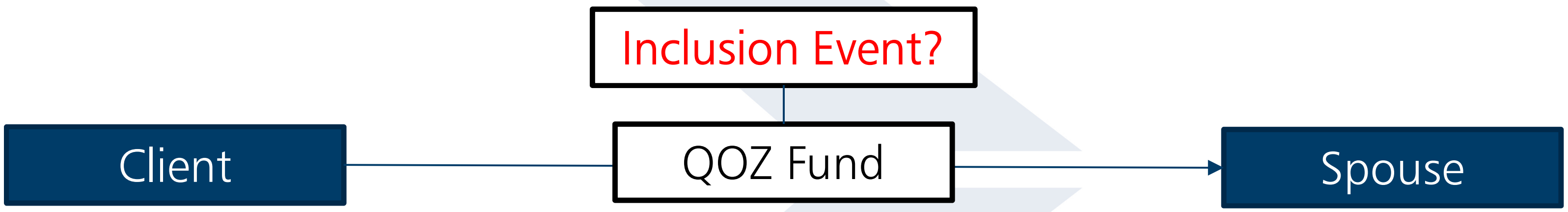
Planning Examples

> Client gifts QOZ Fund Investment to Child
  – Inclusion Event



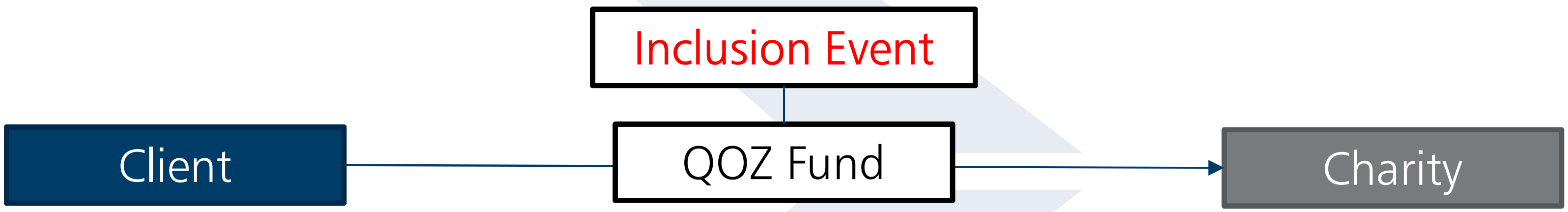
Planning Examples

- > Client gifts QOZ Fund Investment to Spouse
  - – Arguably an Inclusion Event
  - – Does Code § 1041 Override? Need Additional Guidance



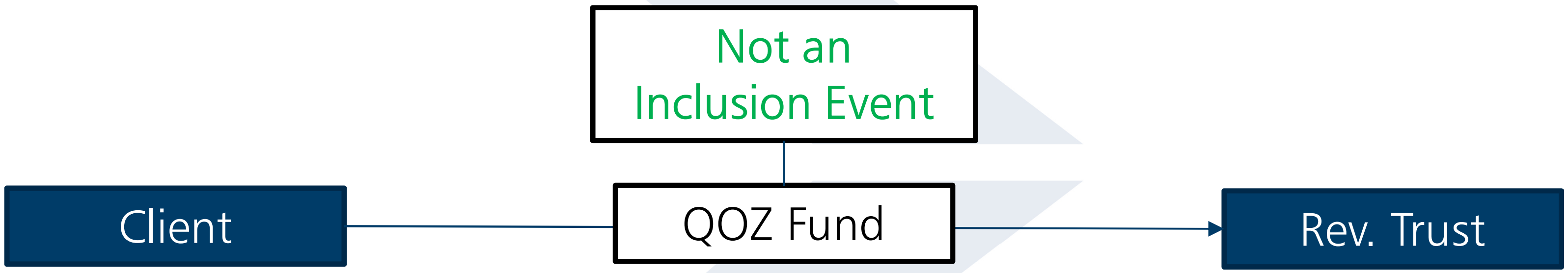
Planning Examples

- > Client gifts QOZ Fund Investment to Charity
  - – Inclusion Event



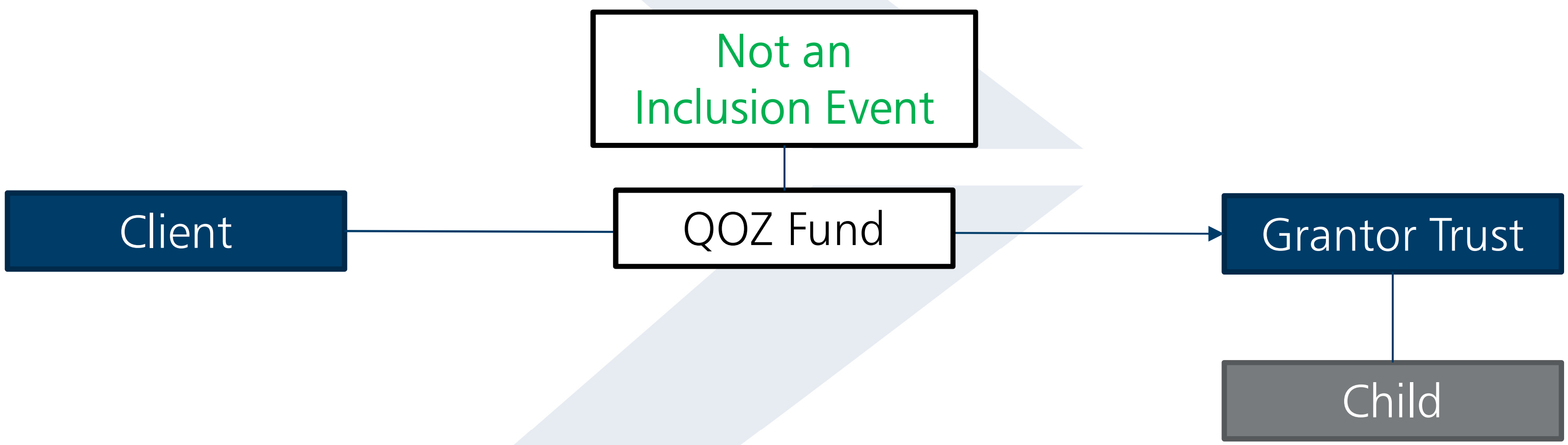
Planning Examples

> For probate avoidance, Client transfers QOZ Fund Investment to Client's Revocable Trust (an incomplete gift to a grantor trust for income tax purposes)
  - Not an inclusion event

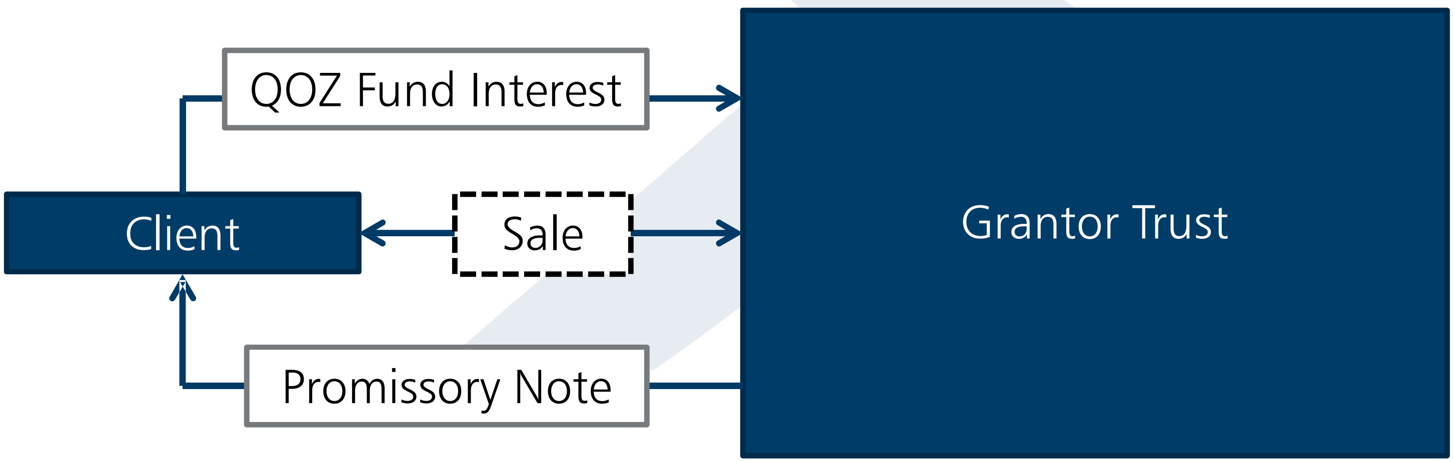


Planning Examples

- > Client gifts QOZ Fund Investment to Grantor Trust for Benefit of Child
  - – Not an inclusion event

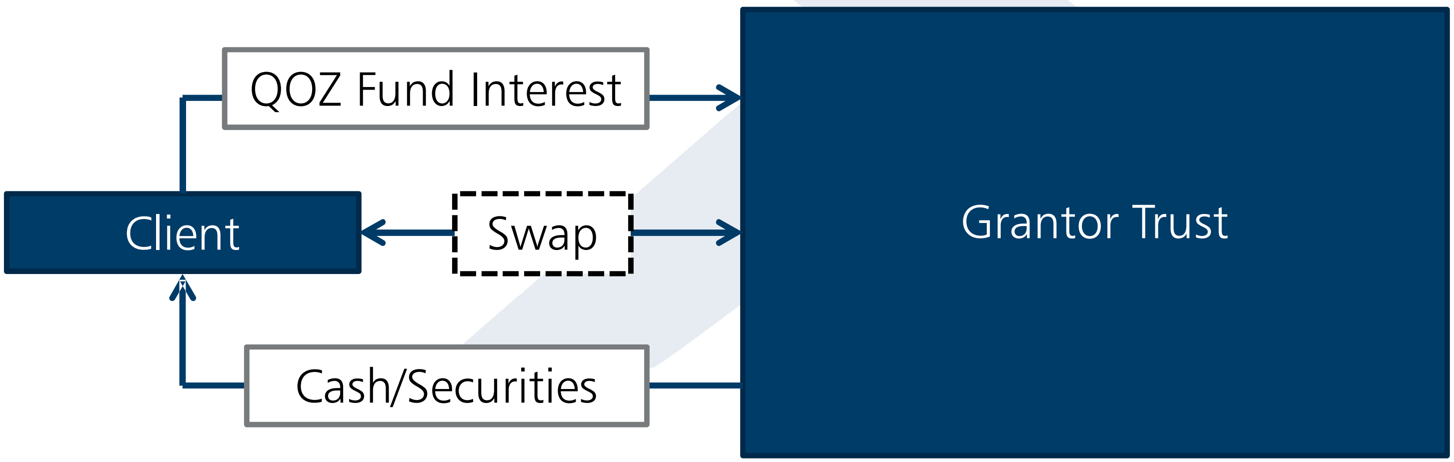


- Client sells QOZ Fund Investment to Grantor Trust for Child for note equal to FMV of QOZ Fund Investment
  - Not clear - regulation provides that a “contribution” by the Grantor to Grantor Trust is not an inclusion event.
  - Is a “sale” the same as a “contribution?”



Planning Examples

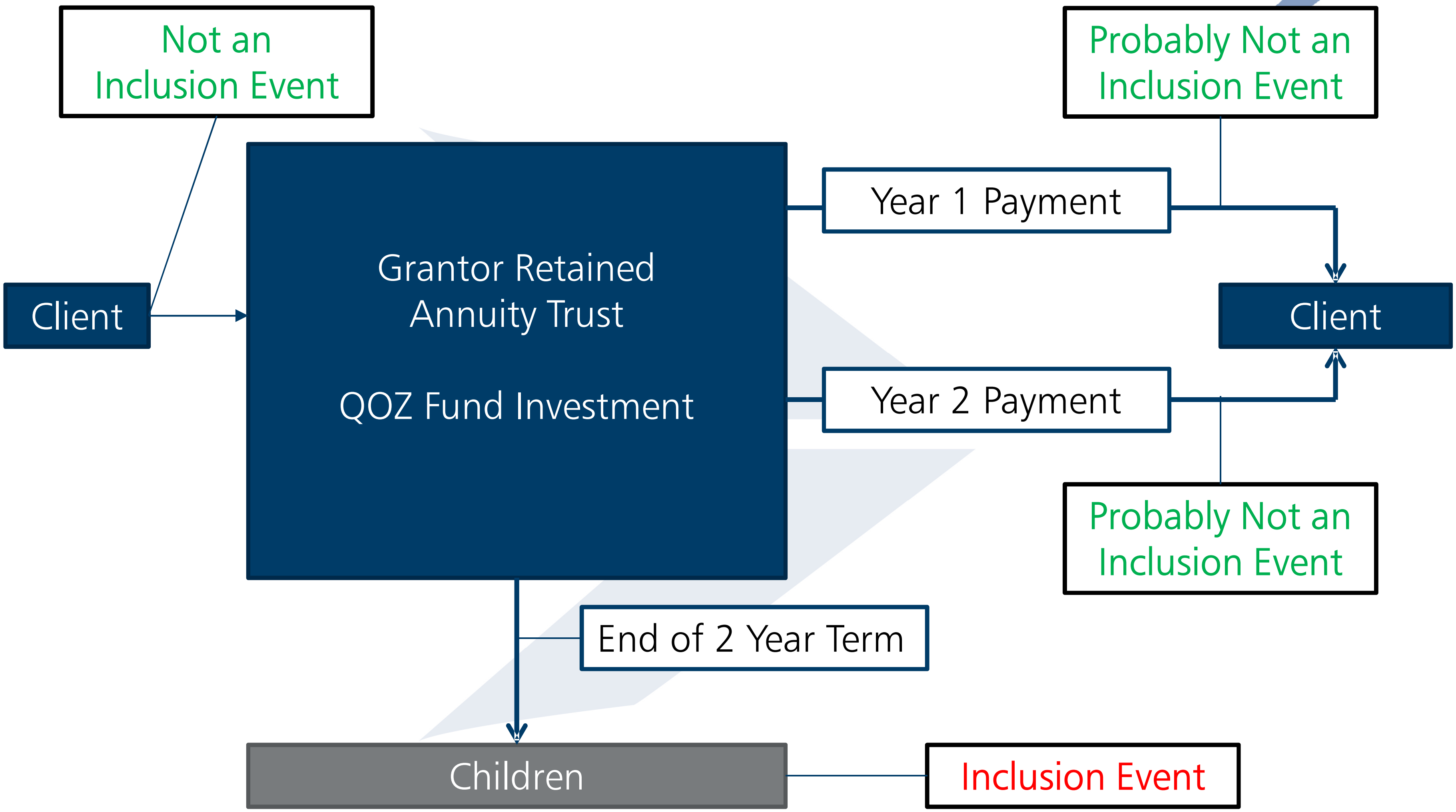
> Client exercises Substitution Power under Code § 675 to "Swap" QOZ Fund Investment in (or out) of Grantor Trust for Assets of Equivalent Value
  - Not clear
  - Is a "substitution" the same as a "contribution"?



Planning Examples

- Client gifts QOZ Fund Investment to GRAT for benefit of Child
  - GRAT is a grantor trust during GRAT Term
    - Contribution is not an inclusion event
  - Is a distribution, in kind, from GRAT (a grantor trust) to Client an inclusion event?
    - Probably not, but not specifically addressed
  - Upon expiration of GRAT, if remainder passes outright to Child or to a non-grantor trust for benefit of Child, this is an inclusion event
    - <u>Planning Pointer</u>: Have GRAT remainder pass to continuing grantor trust for Child

Grantor Retained Annuity Trust



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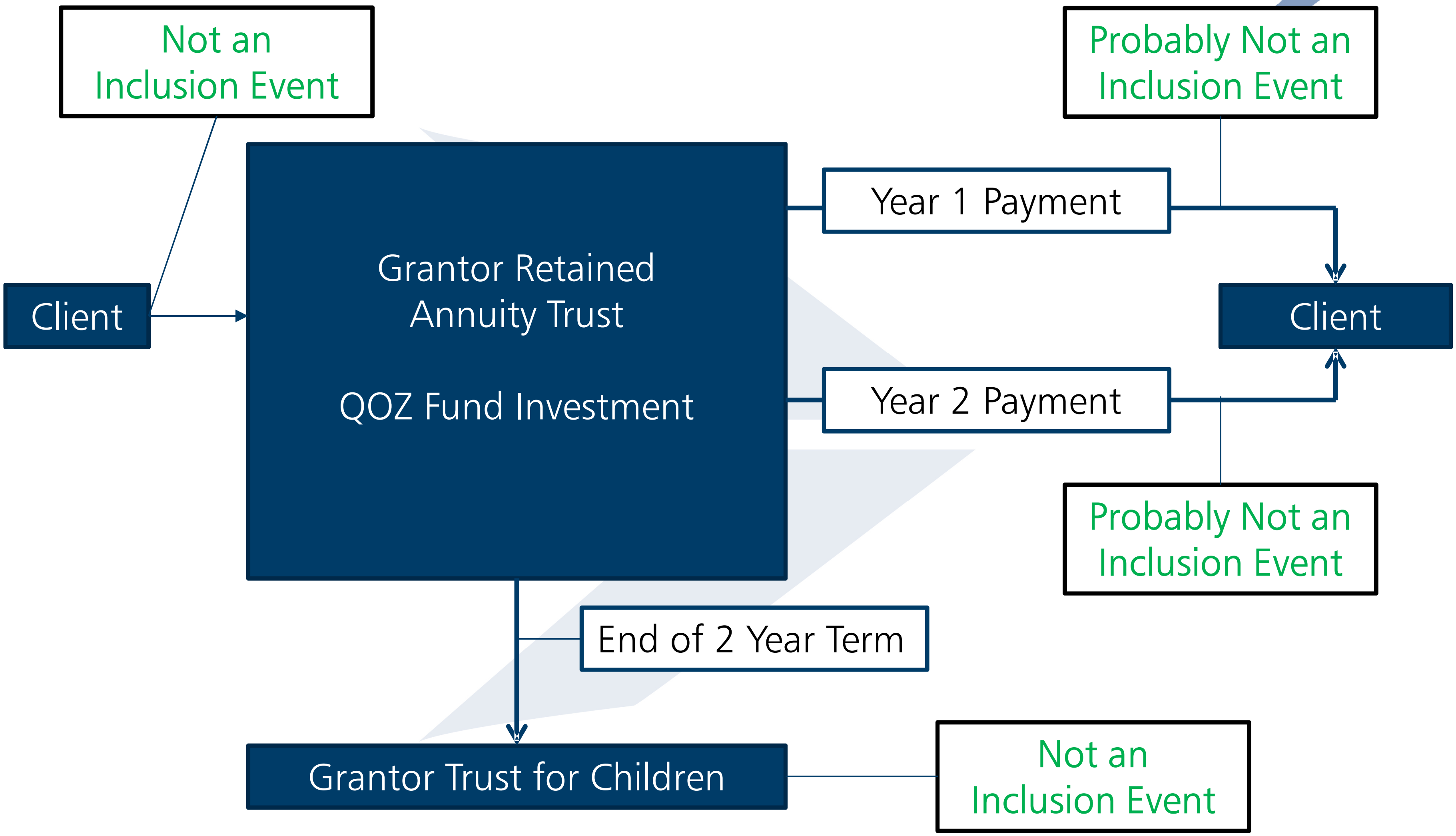
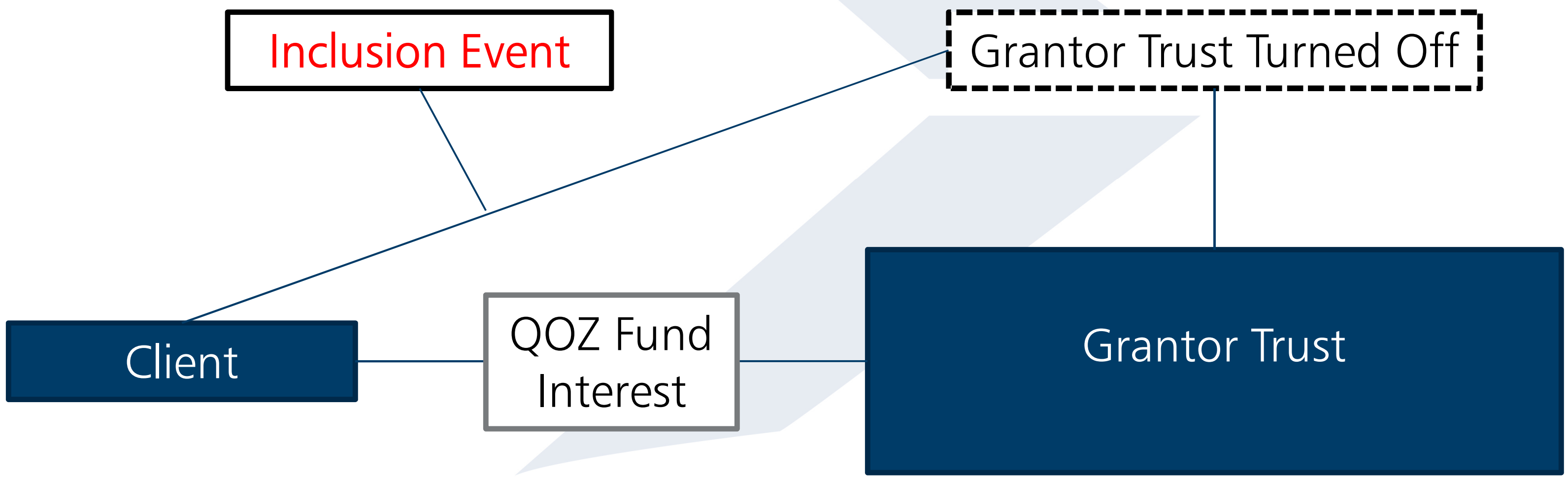
Grantor Retained Annuity Trust



Planning Examples

> Client gifts QOZ Fund Investment to Grantor Trust for Child
  - Grantor Trust "turned off" during Grantor's lifetime
  - Inclusion event when "turned off"
    - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) (First Sentence)



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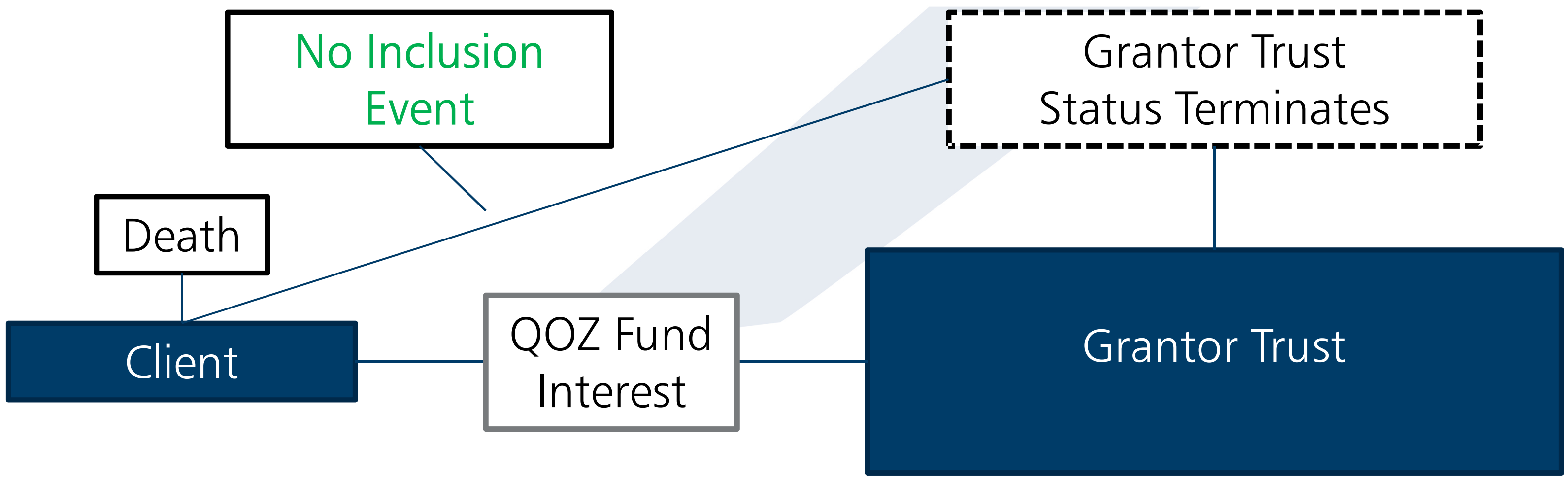
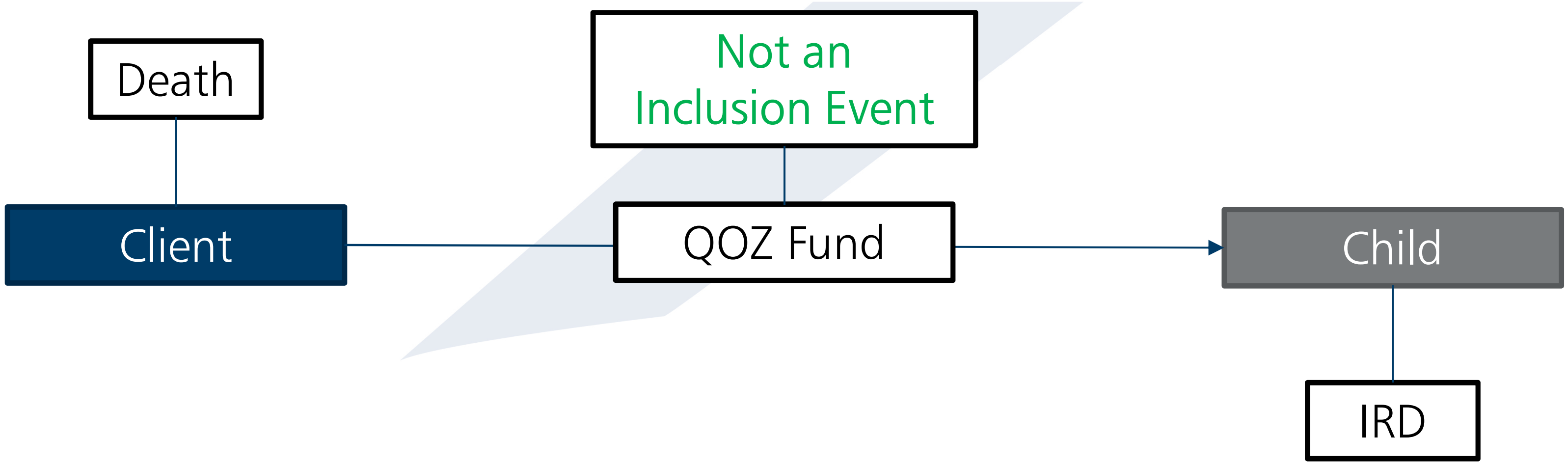
Planning Examples

> Client gifts QOZ Fund Investment to Grantor Trust for Child
  - Client dies, causing grantor trust status to cease
  - Not an inclusion event - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) (Second Sentence)
  - This appears to be a significant concession by the IRS on the question of whether death is a realization event



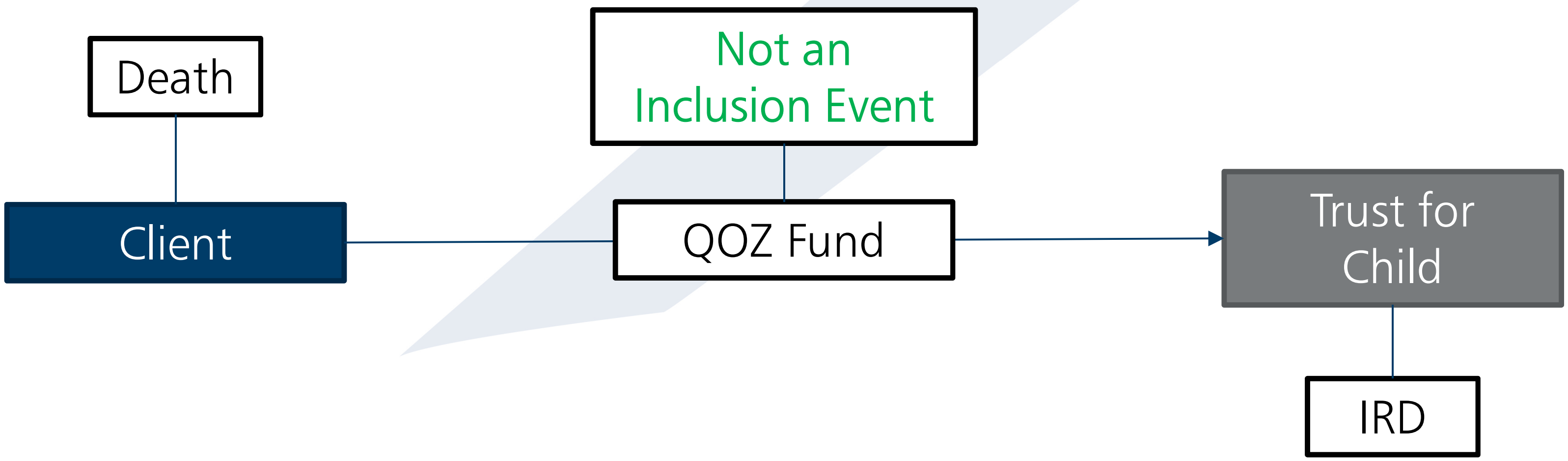
Planning Examples

> Client dies and bequeaths QOZ Fund Investment to Child
  - Not an inclusion event
  - Unpaid capital gain tax is income in respect of a decedent to Child, who must pay tax on deferred gain recognized as of 12/31/26



Planning Examples

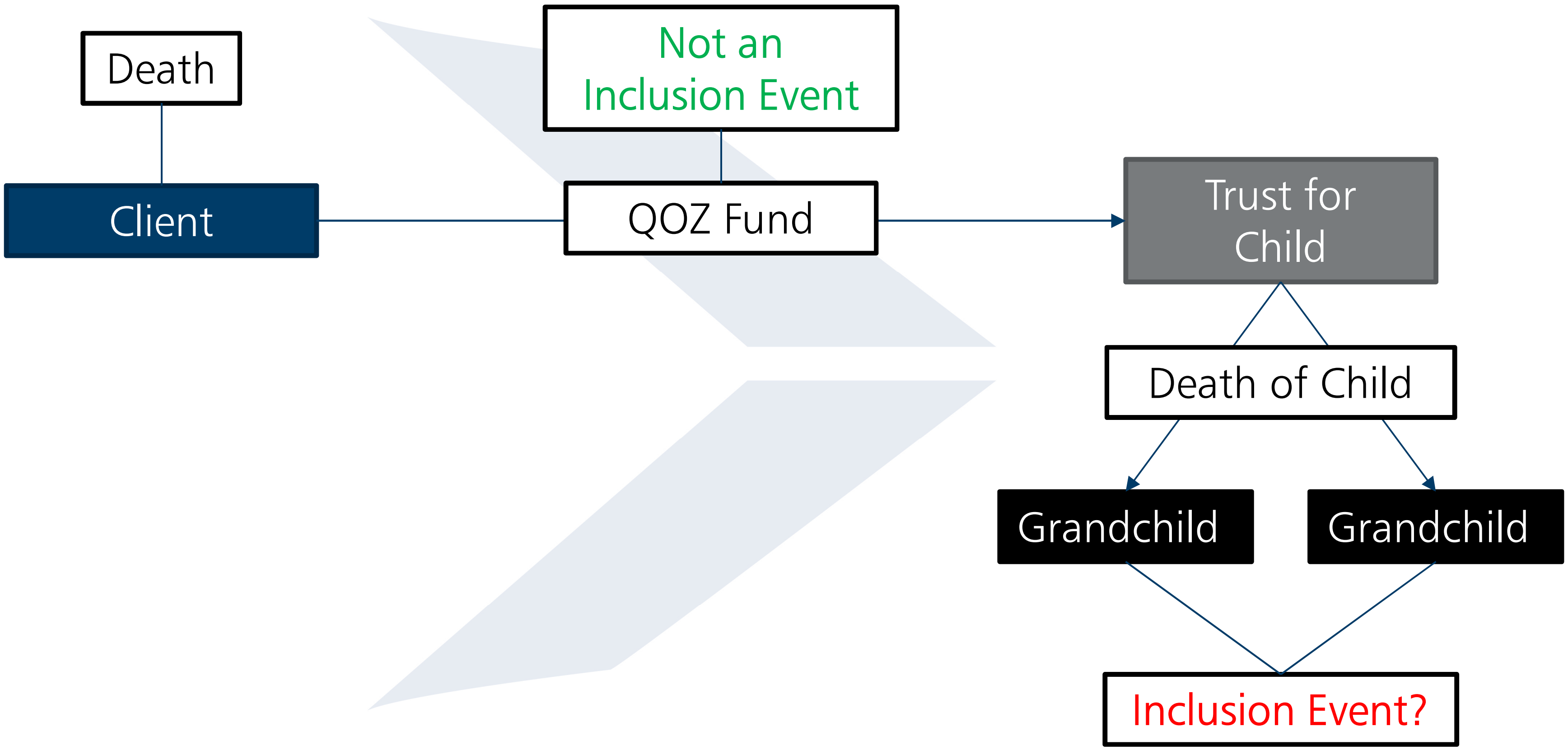
> Client dies and bequeaths QOZ Fund Investment to Trust for Benefit of Child
  - Not an inclusion event
  - Unpaid capital gain tax is income in respect of a decedent to Trust, which must pay tax on deferred gain recognized as of 12/31/26



Planning Examples

> Same facts, but what happens if Trust subdivides at Child's death and is distributed outright to Grandchildren or to separate share trusts for Grandchildren
  – Treas. Reg. 1-1400Z2(b)-1(c)(4)(i)(C) provides "A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death"
  – In this case, it is not the Client's death that is triggering the transfer, it is Child's death that is triggering the transfer
  – Consider using a "pot" trust

Planning Examples



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Qualified Opportunity Funds and Opportunity Zones: What Estate Planners Need to Know

Fiduciary Issues & Investment Considerations

ACTEC / ALI-CLE Webinar

Thursday, May 30, 2019

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Contents

- Fiduciary Duties Relating to Investments

- Select Other Considerations and Practical Issues for a Trustee

- Drafting Considerations

Fiduciary Duties Relating to Investments

Fiduciary Duties Relating to Investments

- Duty of Obedience
- Duty of Care / Duty to Act as a Prudent Investor
- Duty of Loyalty
- Duty of Impartiality

Duty of Obedience

- Requires the fiduciary to carry out the terms of the trust, as established by the settlor.[1]
- Instructions may include, among other things, the investing and managing of assets
- Thus, if a settlor directs the trustee to invest in sustainable investments (QOFs are considered to be sustainable investments) or specifically in QOFs, then the trustee is bound by that direction, unless the trust is modified in an appropriate manner

1. Restatement (Third) of Trusts § 76 (2007).

Duty of Care / Duty to Act as a Prudent Investor

- Requires a fiduciary to act with "reasonable care" and incorporates the "prudent investor rule"
- Under the "Prudent Investor Rule," fiduciaries have a general duty to manage property as a prudent person would, bearing in mind the directions of the settlor and the interests of the beneficiaries
- General History of Fiduciary Investing and Prudent Investor Rule:
  - Modern Portfolio Theory
  - Restatement (Third) of Trusts & the Prudent Investor Rule
  - Uniform Prudent Investor Act (UPIA)

Duty of Care / Duty to Act as a Prudent Investor (continued)

Modern Portfolio Theory

- The “Efficient Portfolio”
- Risk is spread across an investment portfolio by taking into account how an asset’s return correlates to other assets in the portfolio, rather than making investment decisions made on an asset-by-asset basis
- Asset correlation and diversification are key elements to managing risk and improving returns

Duty of Care / Duty to Act as a Prudent Investor (continued)

Restatement (Third) of Trusts & the Prudent Investor Rule

- Prudent investor standard continues to evolve as investment strategies change:

  "[T]he rules must be general and flexible enough to adapt to changes in the financial world and to permit sophisticated, prudent use of any investments and courses of action that are suitable to the purposes and circumstances of the diverse trusts to which the rules will inevitably apply.[1]

1. Restatement (Third) of Trusts, Pt. 6, Ch. 17, Introductory Note (2007).

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- <u>Trustee Considerations - UPIA § 2(a)</u>: "A trustee shall invest and manage trust assets as a prudent investor would, by considering ***the purposes, terms, distribution requirements, and other circumstances of the trust***. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."
- <u>Total Portfolio - UPIA § 2(b)</u>: "A trustee's investment and management decisions respecting individual assets must be ***evaluated not in isolation but in the context of the trust portfolio as a whole*** and as a part of an overall investment strategy having ***risk and return objectives reasonably suited to the trust***."

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Additional Factors - UPIA § 2(c): Circumstances that a trustee shall consider in investing and managing assets include but are not limited to:
  1. General economic conditions
  2. Possible effect of inflation or deflation
  3. Expected tax consequences of investment decisions or strategies
  4. Role of each investment in overall portfolio
  5. Expected total return from income and appreciation of capital
  6. Beneficiaries' other resources
  7. Needs for liquidity, regularity of income, and preservation or appreciation of capital
  8. Asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Typical Characteristics of Investments in QOFs:
  1. Tax benefits of QOF investments held long-term
  2. Long time horizon
  3. Illiquid
  4. Possible need for capital contributions
  5. Need for payment of the deferred capital gains tax when due (earlier of exiting the QOF investment or December 31, 2026)
  6. Cost of the investment in a QOF generally higher than other types of investments due to structure of the investment, due diligence, tax and reporting requirements (possible multiple K-1s), etc.
  7. May have special value to the purposes of the trust, if the trust instrument permits or specifically references “qualified opportunity funds,” “sustainable investments,” “socially responsible investments,” etc.
  8. May have special value to the one or more of the beneficiaries, if a beneficiary or beneficiaries have personal values or the desire to engage in sustainable investing strategies that align with the societal, environmental, governance or other values or beliefs of the beneficiary or beneficiaries

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Duty to Diversify - UPIA § 3: "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, ***because of special circumstances, the purposes of the trust are better served without diversifying***."
- *Post* Case: In *Matter of the Trust of Ray D. Post*,[1] the New Jersey Superior Court held that a trustee breached its fiduciary duties by diversifying trust assets because the sale of those assets violated the grantor's express instructions to retain property originally transferred to the trust. Settlor intent is paramount and trumps the duty to diversify.

1. *Matter of Trust of Ray D. Post*, 2018 N.J. Super. Unpub. LEXIS 1932 (N.J. App. Div. Aug. 15, 2018).

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Duty of Loyalty - UPIA § 5: "A trustee shall invest and manage the trust assets solely in the interests of the beneficiaries." This is opposed to a trustee acting for the trustee's own interest or that of third parties.
  - Comments to UPIA § 5: "No form of so-called ***"social investing"*** is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the beneficiaries -- ***for example, by accepting below-market returns*** -- in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause."
  - However, presumably, in order to receive the tax benefits from investing in a QOF, the investor is seeking above-market returns.

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Reasonable Investment Costs – UPIA § 7: "In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."
- Cost of investments in a QOF generally higher than other types of investments due to structure of the investment, due diligence, tax and reporting requirements (possible multiple K-1s), etc.

Duty of Loyalty

- Duty of Loyalty - UPIA § 5: "A trustee shall invest and manage the trust assets solely in the interests of the beneficiaries." This is opposed to a trustee acting for the trustee's own interest or that of third parties.
  - Comments to UPIA § 5: "No form of so-called ***"social investing"*** is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the beneficiaries -- ***for example, by accepting below-market returns*** -- in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause." Emphasis added.
  - However, presumably, in order to receive the tax benefits from investing in a QOF, the investor is seeking above-market returns.

Duty of Impartiality

- Duty of Impartiality - UPIA § 6: "If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries."
- Different beneficiaries may have different values and desires to support an investment in a QOF.

Select Other Considerations and Practical Issues for a Trustee

Select Other Considerations and Practical Issues for a Trustee

- QOFs structured as indirect investments through funds typically are either single-asset funds or multi-asset funds. The QOF structure may affect how a Trustee invests and manages the QOF investment.

	SINGLE-ASSET FUND	MULTI-ASSET FUND
GENERAL STRUCTURE	• Single asset / project in a single entity	• Multiple assets / projects, each of which is held in a separate, parallel entity (*e.g.*, LLC) because fund-of-fund structure is prohibited
USE OF CAPITAL	• Front-loaded – capital raised and put to work quickly	• Elongated - capital raised and put to work over time
CONSIDERATIONS	• Concentration of investor's capital – concentration risk but may be easier to structure and operate • Easier for investor to match with 180-day period for investment of capital gains • Easy for investors with large realized gains who need to quickly identify a suitable QOF within 180 days of realization	• Diversified portfolio but more complicated structure • Multiple capital calls during life of fund and harder to match each capital call with 180-day period for investment of capital gains (higher likelihood of a "mixed investment") • Better for investors who have large unrealized gains but have control over gain realization timing or have rolling, dependable gains (*i.e.*, have reasonable certainty/predictability of expected gains)

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Select Other Considerations and Practical Issues for a Trustee (continued)

- Paying the Tax in 2026: In 2026, taxpayers will need to pay the deferred capital gains tax on the original capital gains and they should have a plan to pay.
  - Conservative approach: Pay the deferred capital gains tax using outside assets.
  - Distributions from a QOF: Some QOFs plan on making distributions to the investors so investors can pay the deferred capital gains tax. But distributions from QOFs would constitute an inclusion event to the extent the distributions exceed a taxpayer's basis.

Select Other Considerations and Practical Issues for a Trustee (continued)

- <u>Combining QOZ Tax Benefits with Other Tax Benefits</u>: It is possible for a QOF to claim income tax credits and other tax benefits. However, further guidance is needed on the interaction among the QOZ rules and other tax provisions (*e.g.*, IRC § 45D new markets tax credit, IRC § 42 low-income housing tax credit).
  - Example - IRC §§ 1202 and 1045 Qualified Small Business Stock (QSBS) Exclusion and QSBS Rollover
    - Take QSBS exclusion from capital gains upon sale of QSBS shares and then use the excess capital gain above the QSBS exclusion that would be recognized to either (1) roll over into another QSBS investment under IRC § 1045 (which also could be a QOF) or (2) invest in a QOF.

Drafting Considerations

Drafting Considerations

New Trust

- When a client is creating a new trust and is interested in the trust being able to invest in and hold investments in QOFs or sustainable investments, the trust should be designed to be flexible to accommodate those investments, however those investments may be structured (*e.g.*, direct investment or indirect funds).
  - Settor's Intent & Trust Purpose: Expressly state that the purpose of the trust is to invest with a sustainable lens (*e.g.*, that the trustee may invest taking into account the revitalization of distressed communities) and authorize the trustee in making investment decisions taking this purpose and the settlor's wishes into account.
  - Directed Trust Language: Build flexibility into the trust instrument by including directed trust provisions.
  - Flexibility to Make Administrative Changes to the Trust: Provide flexibility in the trust instrument to change the administrative provisions of the trust, if needed to carry out the settlor's intent for the trust to make investments in QOFs or sustainable investments (*e.g.*, change of situs and governing law provisions, trust protector provisions with the power to modify the administrative provisions of the trust and/or achieve the purpose of the trust or for tax advantages, other ways to modify the trust).

Drafting Considerations

Existing Trust

- If it is unclear whether the trust instrument permits investments in QOFs:
  - Clarify the Existing Trust (using judicial construction, non-judicial settlement agreement, or non-judicial consent agreement)
  - Modify the Existing Trust (using powers of appointment, judicial reformation, judicial modification, non-judicial settlement agreement, non-judicial consent agreement, decanting, merger)

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Qualified Opportunity Zones:

*What Estate Planners Need to Know**

Chicago Estate Planning Council

December 12, 2019

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* Unless otherwise noted, these materials were initially prepared for the telephone seminar and audio webcast of "Qualified Opportunity Funds and Opportunity Zones: What Estate Planners Need to Know" by The American Law Institute Continuing Legal Education (ALI-CLE) and co-sponsored by The American College of Trust and Estate Counsel (ACTEC). They are reprinted here with the permission of the ALI-CLE, ACTEC and the authors of the materials, Kevin Matz, Farhad Aghdami, Todd Angkatavanich, and Benetta Jenson.

Overview

- The 2017 Tax Cuts and Jobs Act includes a new tax incentive provision that is intended to promote investment in economically-distressed communities, referred to as "Opportunity Zones." Through this program, investors can achieve the following three significant tax benefits:

1. The deferral of gain on the disposition of property to an unrelated person until the earlier of the date on which the subsequent investment is sold or exchanged, or December 31, 2026, so long as the gain is reinvested in a "Qualified Opportunity Fund" within 180 days of the property's disposition;
2. The elimination of up to 15% of the gain that has been reinvested in a "Qualified Opportunity Fund" provided that certain holding period requirements are met; and
3. The potential elimination of tax on gains associated with the appreciation in the value of a Qualified Opportunity Fund, provided that the investment in the Qualified Opportunity Fund is held for at least ten years.

Opportunity Zones

- An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.
- Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Internal Revenue Service (IRS).
- All Opportunity Zones have now been designated, as of June 14, 2018, and are available on the U.S. Department of Treasury website. *See* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

Qualified Opportunity Funds

- A Qualified Opportunity Fund, in turn, is an investment vehicle that is established as either a domestic partnership or a domestic corporation for the purpose of investing in eligible property that is located in an Opportunity Zone and uses investor gains from prior investments as a funding mechanism.
- The investor can get the tax benefits of Opportunity Zones even if the investor doesn't live, work or maintain a business in an Opportunity Zone – the investor just needs to invest in a Qualified Opportunity Fund.

Qualified Opportunity Funds

- To become a Qualified Opportunity Fund, the entity self-certifies itself by attaching Form 8996 to the entity’s timely filed federal income tax return for the taxable year taking into account extensions
- The entity must meet certain requirements, in particular a general requirement that at least 90% of its assets be “qualified opportunity zone property” used within an Opportunity Zone (as further discussed below), but no approval or action by the IRS is required.

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- To qualify for these tax benefits, the investor's reinvestment in the Qualified Opportunity Fund must occur during the 180-day period beginning on the date of the sale.
  - The Proposed Regulations provide some relief in the case of certain pass-through entities.
- Under IRC section 1400Z-2(a)(2), the taxpayer may elect to defer the tax on some or all of that gain.
- If, during the 180-day period, the taxpayer invests in one or more Qualified Opportunity Funds an amount that was less than the taxpayer's entire gain, the taxpayer may still elect to defer paying tax on the portion of the gain invested in the Qualified Opportunity Fund.
- If, in contrast, an amount in excess of the taxpayer's gain is transferred to the fund (a so-called "investment with mixed funds"), the taxpayer is treated, for tax purposes, as having made two separate investments -- one that only includes amounts as to which the investor's deferral election is made, and a separate investment consisting of other amounts.

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- Importantly, the law requires only that the ***gain*** be reinvested in the Qualified Opportunity Fund, and not the total sales proceeds.
  - The Proposed Regulations have clarified that, in general, only capital gains are eligible to be invested in a Qualified Opportunity Fund
- In addition, in contrast to Section 1031 “like-kind” exchanges (another mechanism of gain deferral through reinvestment), in the Qualified Opportunity Funds context the cash from the sale does not need to be specifically tracked or escrowed.
- Instead, the requirement is merely that an amount of cash equal to the gain on the sale be reinvested in a Qualified Opportunity Fund within 180 days of the property’s disposition (subject to potential relief in the case of certain pass-through entities).

Deferral of Gain Through Timely Reinvestment in QOF and Possible Exclusion from Income of Up to 15% of Such Gains if the Reinvestment is Held for At Least 7 Years

- The taxpayer's basis in the Qualified Opportunity Fund is initially zero, but will be increased by 10% of the deferred gain if the investment in the Qualified Opportunity Fund is held for 5 years, and increased by an additional 5% (to 15% of the deferred gain in total) if the investment in the Qualified Opportunity Fund is held for 7 years.
- Thus, if a gain on the sale of property is timely reinvested in a Qualified Opportunity Fund, the taxpayer may be able to decrease the taxable portion of the originally deferred gain by 15% (via a corresponding basis step-up) if the investment in the Qualified Opportunity Fund is held for at least 7 years.
- The taxpayer makes an election to defer the gain, in whole or in part, when filing the tax return on which the tax on that gain would otherwise be due if it were not deferred.

Exclusion of Gain on Appreciation in the Value of QOF if Held for At Least 10 Years

- The tax incentives of this program go well beyond tax deferral (even putting aside the potential basis adjustments discussed above), as subsequent gain on the appreciation in the value of the Qualified Opportunity Fund is capable of being ***fully excluded from income***.
- In order to qualify, the investor must hold its reinvestment in the Qualified Opportunity Fund for at least 10 years.

QOF Requirements

- An entity must meet certain requirements to qualify as a QOF.
- Specifically, a QOF must meet a test (the “90% Asset Test”) whereby 90% of its assets, measured every 6 months and averaged for each year, must be qualifying “QOZ Property.”
- To meet this requirement, a QOF may (i) directly own “QOZ Business Property” or (ii) may own a QOZ Business that in turn owns QOZ Business Property.
- A QOF may not, however, own (as a qualifying asset) an interest in another QOF.
- A QOZ Business must (i) have “substantially all” of its tangible assets invested in QOZ Business Property, (ii) meet certain requirements under Section 1397C regarding permissible assets (including a general prohibition against owning more than 5% nonqualified financial assets such as cash), and (iii) comport with certain “sin business” prohibitions under section 144(c)(6)(B).

QOF Requirements

- **QOZ Business Property** means, in general, **tangible property acquired by purchase from an unrelated party**, which property either is "**originally used**" in the QOZ by the QOF or QOZ Business, **or** is "**substantially improved**" by the QOF or QOZ Business (meaning, generally, improvements over a period of 30 months that result in a 100% increase to the adjusted basis of the property).
- Section 1397C generally governs the rules applicable to tax credits for so-called "enterprise zone businesses."
  - Several of these provisions – section 1397C(b)(2), (b)(4) and (b)(8) – are incorporated into the QOZ rules by reference.
- "Relatedness" for this purpose is generally determined by a 20% or greater common ownership test taking into account certain constructive ownership rules.

Effect of Death

- Section 1400Z-2(e)(3) provides that, "[i]n the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691."
- This statutory provision raises questions concerning the appropriate treatment of the deferred gain where a person who has rolled over gain through a timely investment in a QOF dies prior to December 31, 2026 without having previously disposed of the QOF investment.
- Section 691 sets forth the rules that apply to a person's receipt of income in respect of a decedent ("IRD").
  - IRD refers to income earned by a decedent who was a cash basis taxpayer prior to his or her death, but that is not properly includible in income until after the decedent's death. IRD is not reportable on the decedent's final income tax return.
  - Rather, it is reportable by the recipient of the IRD item (e.g., by the decedent's estate or some other person).

Special Rule that Caps Gain at Fair Market Value at Date of Triggering Event

- 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. It provides as follows:

- **1400Z-2(b)(2) AMOUNT INCLUDIBLE.—**
- **1400Z-2(b)(2)(A) IN GENERAL.—** The amount of gain included in gross income under subsection (a)(1)(A) shall be the excess of—
- **1400Z-2(b)(2)(A)(i)** the lesser of the amount of gain excluded under paragraph (1) or the fair market value of the investment as determined as of the date described in paragraph (1), over
- **1400Z-2(b)(2)(A)(ii)** the taxpayer’s basis in the investment.

The 1st Round of Proposed Regulations

- On October 19, 2018, the Internal Revenue Service released the first set of proposed regulations (the "Proposed Regulations") and Revenue Ruling 2018-29 (the "Revenue Ruling") clarifying certain aspects of the Qualified Opportunity Zone ("QOZ") provisions added by the tax reform legislation enacted in December 2017.
- The IRS indicated that it expected to issue additional guidance before the end of 2018 (which did not happen), and the IRS requested comments on a number of provisions in the Proposed Regulations.
- The Proposed Regulations state that they may apply to transactions occurring before the finalization of such regulations, provided they are applied consistently.

The 1st Round of Proposed Regulations

Only Capital Gains Eligible for Reinvestment

- The Proposed Regulations provide that only capital gains may be “rolled over” into a QOZ investment.
  - ➢ This would preclude ordinary income from the sale of inventory (and possibly would preclude gain recharacterized as ordinary income under certain “recapture” rules).

The 1st Round of Proposed Regulations

Partners in Pass-Through Entities May Reinvest Share of Entity's Gains from Asset Sales

- The Proposed Regulations include special provisions by which gain recognized by a partnership may (except to the extent the partnership elects to rollover the gain itself) flow through to the partners and be reinvested by such partners into qualified opportunity funds ("QOFs").
  - It was previously unclear whether the partner or the partnership had to make such reinvestment.

The 1st Round of Proposed Regulations

Partners in Pass-Through Entities May Reinvest Share of Entity's Gains From Asset Sales (cont'd)

- In addition, there is the potential for such partners to have an increased period during which to reinvest gain into a QOF.
- The partnership's 180-day period begins on the date of its sale, but if the gain flows through to the partners, the partners' 180-day period begins on the last day of the partnership's taxable year.
- Partners may instead elect to use the partnership's 180-day period if they so desire (e.g., if the desired investment is already lined up).

The 1st Round of Proposed Regulations

QOFs Always Tested at End of Calendar Year

- The Proposed Regulations clarify that, while the initial testing date for a QOF (for purposes of the 90% asset test, discussed below) may be as long as six months after the QOF’s start date, there is *always* a testing date on the last day of the calendar year.
  - Accordingly, QOFs that are formed near the end of a calendar year may need to meet the 90% asset test sooner than expected.
- The Proposed Regulations do, however, provide flexibility for QOFs to select the date on which they begin to qualify (although QOFs must qualify as such prior to receiving investments for such investments to qualify under the QOZ provisions), and for taxpayers to use pre-existing entities as QOFs.

The 1st Round of Proposed Regulations

LLCs Likely Permitted

- The Proposed Regulations state that QOFs may include entities treated as partnerships for federal income tax purposes, which would presumably permit the use of limited liability companies.

Investors May Hold Investments Past Expiration of QOZ Designation

- Although the statute provides that the QOZ designations expire after 10 years, the Proposed Regulations permit investors seeking to take advantage of the 10-year rule to hold their investments for an additional 20-year period — until December 31, 2047 — and still receive the benefit of the exclusion from income of all post-acquisition appreciation.

The 1st Round of Proposed Regulations

Treatment of Land

- The Proposed Regulations and Revenue Ruling provide that land is treated separately from the improvements thereon for purposes of the substantial improvement test, and provide several important clarifications regarding the treatment of land.

- The Revenue Ruling provides that land, given its permanence, may *never* be treated as originally used by a QOF in a QOZ.
  - ➢ However, the examples in the Revenue Ruling indicate that the land may qualify as QOZ Business Property if the improvements thereon qualify, even if such land is not improved.
  - ➢ Accordingly, for the substantial improvement test, a QOF need only substantially improve the *building* on a parcel of acquired land in order for the entire parcel to qualify for the 90% asset test.

The 1st Round of Proposed Regulations

Treatment of Land (cont'd)

- In addition, the example in the Revenue Ruling involves the conversion of a factory building into residential rental property.
  - ➢ As the building was already in existence and is being modified (rather than a new one being constructed), it must meet the substantial improvement test rather than the original use test.
  - ➢ The example also seems to confirm that residential rental property does indeed qualify as potential QOZ property.

The 1st Round of Proposed Regulations

QOZ Business "Substantially All" Requirement to Mean at Least 70%

- QOFs may own QOZ businesses (rather than directly owning qualified opportunity zone property), with the requirement that a QOZ business have "substantially all" of its assets be qualified opportunity zone property.
- The Proposed Regulations provide that, solely for this purpose, "substantially all" means at least 70%.
- Accordingly, a QOF that owns a QOZ business may have as little as 63% of its capital invested in qualified opportunity zone property (90% in the QOZ business, per the 90% asset test, times 70% of the business's property).
- This may provide additional flexibility as to the timing of capital investments into a QOF and the use of such capital.

The 1st Round of Proposed Regulations

Working Capital Safe Harbor

- The Proposed Regulations provide certain safe harbors relating to working capital and asset composition of a QOF to the extent that such assets are held in QOZ businesses.
- Specifically, the "reasonable working capital" safe harbor of Section 1397C(e)(1) of the Internal Revenue Code now also extends to QOZ businesses for a period of 31 months.
- Thus, a QOZ business can have as long as 31 months to deploy working capital provided that the documentation requirements contained in the Proposed Regulations are satisfied.

The 1st Round of Proposed Regulations

Working Capital Safe Harbor (cont'd)

- The IRS's instructions to the Form 8996 describe these documentation requirements in terms of the following four-part test that must be satisfied:
  - ➢ (1) The working capital is designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone.
  - ➢ (2) There is a reasonable written schedule for the expeditious consumption of the working capital to achieve the goal set out in (1) above.
  - ➢ (3) The working capital will be completely consumed no later than 31 months after the amounts are first invested in eligible interests in the relevant QOF.
  - ➢ (4) The working capital is consumed in a manner that is substantially consistent with the requirements in items (1) through (3).

The 1st Round of Proposed Regulations

Working Capital Safe Harbor (cont'd)

- Additional helpful clarification on the working capital safe harbor was provided in Treasury's second tranche of proposed regulations that was released in April 2019.
- The new proposed regulations give additional flexibility to the working capital safe harbor, including by allowing the written working capital schedule to provide for expenditures for broader costs of business operation, rather than only for the acquisition of qualifying QOZ business property.
- This safe harbor also will not be violated in the 31-month period is exceeded due to delays in receiving governmental approvals.

The 1st Round of Proposed Regulations

Comment Letters

- A number of organizations including the American College of Trust and Estate Counsel (ACTEC) submitted comment letters to address open points in the legislation and the 1st Round of Proposed Regulations.
  - ACTEC's comments may be found at this link:

  https://www.actec.org/assets/1/6/ACTEC-comments-to-Treasury-re-Qualified-Opportunity-Funds-2018-12-27.pdf

ACTEC's Comments to the 1st Round of Proposed Regulations

- ACTEC's comments to the 1st round of proposed regulations addressed 4 key points:
  - 1. A request for clarification concerning the income tax consequences resulting from the death of a taxpayer who has deferred gain through a timely reinvestment of gain in a QOF, including a request to provide relief for successors-in-interest
    - *The concern here is that the estate beneficiary or other successor-in-interest of the QOF interest may not have the liquidity necessary to pay the deferred tax that becomes due at that time.*
    - *This could be particularly problematic if the fund does not contain redemption provisions, or if a secondary market for the interest in the fund has not matured.*
    - *Does tacking of the holding period apply in the case of death?*

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 2. A request for clarification concerning the income tax consequences resulting from the gift of an interest in a QOF where the donor has deferred gain through a timely reinvestment of gain in a QOF

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 3. A request for clarification concerning grantor trusts, including to confirm that a transaction with a grantor trust that is disregarded for income tax purposes pursuant to Rev. Rul. 85-13 should not be considered a sale or exchange of an interest in a QOF
  - *Clarification was requested that it should not matter whether the gain that is sought to be deferred, or the funds that are subsequently invested in the QOF, belong to the taxpayer or the taxpayer's grantor trust*
  - *Does tacking of the holding period apply in the case of transactions with grantor trusts?*

ACTEC's Comments to the 1st Round of Proposed Regulations (cont'd)

- 4. A request to provide relief to extend the 180-day period for rollover of gain to a QOF to partners, S corporation shareholders and beneficiaries of estates and trusts because they may not receive a Schedule K-1 indicating capital gains until more than 180 days after the end of the taxable year
  - *ACTEC proposed that the time to rollover the gain be the later of (i) 180 days after the end of the relevant tax year (which is the current rule under the proposed regulations) and (ii) 180 days after the timely filing (taking into account extensions) of the tax return for the partnership, S corporation, estate or trust that has incurred such gain*

The Second Round of Proposed Regulations

- On April 17, 2019, Treasury released its second round of proposed regulations on QOFs.
- The due date for the submission of Comments to Treasury on these proposed regulations is July 1, 2019.

Estate Planning with QOZs

Farhad Aghdami

WILLIAMS MULLEN

Background

> **The Opportunity Zone Program**

- Enacted on December 22, 2017 as part of the Tax Cuts & Jobs Act
  - Bipartisan effort that was originally initiated in Feb. 2017 by Senators Tim Scott (R-SC) and Corey Booker (D-NJ)
  - Builds on/improves upon incentives provided under existing programs (e.g., NMTCs)
- Intended to encourage private investment in communities that are in need of resurgence
  - Not only “placed-based,” but “property-based”

Opportunity Zones

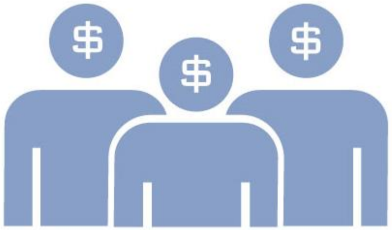
> **Opportunity Zones (“OZs”)**
– Designated low-income communities
    - Population census tracts designated as “low-income communities” per the NMTC program
    - Limited to 25% of the eligible low-income communities within the state
    - Nominations were made by the chief executive officer of each state in early 2018
– Treasury certified those nominations and designated opportunity zones in each state in April – June 2018

The OZ Incentives

> **Operative Through Basis Adjustments**

- Eligible investments in QOFs
  - Initial tax basis = $0
    - Preserves investor's unrecognized capital gain
  - Holding period basis increases:
    - At least 5 years prior to 12/31/26 = 10%
    - At least 7 years prior to 12/31/26 = 15%
  - FMV basis increase:
    - Basis = FMV on date of sale/exchange of QOF investment
      - » Must hold investment for at least 10 years prior to 12/31/47

The OZ Incentives



Investors with eligible capital gains

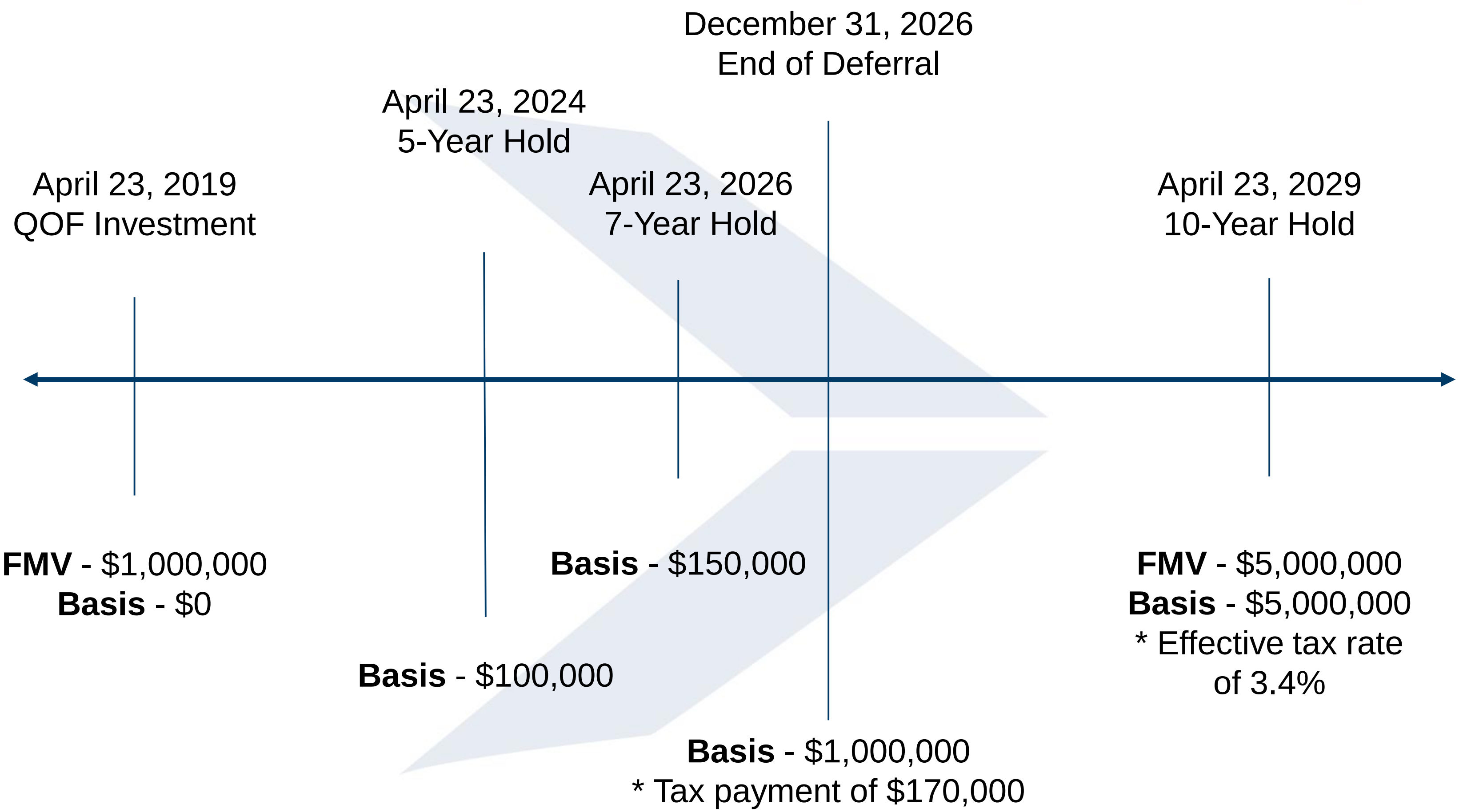
Qualified Opportunity Fund ("QOF") Investment

Temporary
DEFERRAL
Through 12/31/26
Or earlier "Inclusion Event"

Permanent
TAX REDUCTION
Up to 15%

Permanent
TAX AVOIDANCE
For QOF interests held for 10+ years

Example – Basis Adjustments



* Example assumes a 20% tax rate

Current & Anticipated Guidance

> **Statute Enacted December 22, 2017**

> **Proposed Regulations**

  – First tranche of proposed Regulations issued October 2018
    - Rev. Rul. 2018-29 issued simultaneously
  – Second tranche of proposed Regulations issued April 17, 2019

> **Technical Corrections**

  – On January 2, 2019, the Joint Committee on Taxation issued a draft of its "Tax Technical and Clerical Corrections Act" that included changes to the OZ statute

Inclusion of Deferred Gains

- > **Second Set of Proposed Regulations Issued April 17, 2019**
- > **General Rule on Transfers**
  - – Any disposition of the owner's qualifying investment is an inclusion event
  - – A taxpayer receives property in a transaction that is treated as a distribution for Federal income tax purposes, whether or not the receipt reduces the taxpayer's ownership of the QOF
  - – A taxpayer claims worthlessness deduction with respect to its qualifying investment.
    - Treas. Reg. § 1.1400Z2(b)-1(c)(1)

Estate Planning Related Transfers

> **Transfer of Qualifying Investment by Gift**

– A taxpayer's transfer of a qualifying investment by gift, whether outright or in trust, is an inclusion event, <u>regardless</u> of whether that transfer is a <u>completed</u> gift for Federal gift tax purposes, and regardless of the <u>taxable</u> or <u>tax-exempt</u> status of the donee of the gift.

- Treas. Reg. § 1.1400Z2(b)-1(c)(3)

> **Charitable Contributions**

– The Preamble to the Regulations confirms that a charitable contribution of a qualifying interest is also an inclusion event because the owner's qualifying investment is terminated upon the transfer.

Estate Planning Related Transfers

> **Grantor Trusts**

– If the owner of a qualifying investment *contributes* it to a grantor trust, the owner of the investment is the deemed owner of the trust, the *contribution* is not an inclusion event. (Emphasis added)

- Treas. Reg. § 1.1400Z2(b)-1(c)(5)(i)
- The rationale for this exception is that the owner of the grantor trust is treated as the owner of the property in the trust until such time that the owner releases certain powers that cause the trust to be treated as a grantor trust.

Estate Planning Related Transfers

> **Grantor Trusts**

- However, any change in the grantor trust status of the trust (<u>except by reason of the grantor's death</u>) is an inclusion event because the owner of the trust property for Federal income tax purposes is changing.
  - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii)
- Favorably, neither the termination of grantor trust status by reason of the grantor's death, nor the distribution by that trust to a trust beneficiary by reason of the grantor's death is an inclusion event.
  - *See also*, Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)

Estate Planning Related Transfers

> **Death**

- Most transfers by reason of death will terminate the owner's qualifying investment.
- For example, the qualifying investment may be distributed to a beneficiary of the owner's estate or may pass by operation of law to a named beneficiary. In each case, the owner's qualifying investment is terminated.
- Distribution of the qualifying investment to the beneficiary by the estate or by operation of law is not an inclusion event.
  - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii)

Transfers By Reason of Death

> **Transfers By Reason of Death Include the Following:**

- 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; and
- Any other transfer of a qualifying investment at death by operation of law.
- Treas. Reg. § 1.1400Z2(b)-1(c)(4)(i)

Transfers By Reason of Death

> **Transfers By Reason of Death <u>Excludes</u> the Following:**

- A sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than an excluded distribution described in paragraph (c)(4)(i)
- 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
- Treas. Reg. § 1.1400Z2(b)-1(c)(4)(ii)

Estate Planning Related Transfers

> **Inclusion Event**

  – The gain to which a deferral election applies is included in gross income in the taxable year that includes the earlier of (1) the date of the inclusion event or (2) December 31, 2026

Income In Respect of a Decedent

> Code 1400Z-2(e)(3) provides:

"*In the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691*."

> In each estate planning related transfer where there is no inclusion event in connection with the transfer, the <u>transferee</u> of the qualifying investment has the obligation under Code Section 691 to include the deferred gain in gross income in the event of any subsequent inclusion event, including for example, any further disposition by that recipient.

Basis

- > No Basis Adjustment Under Code § 1014 at Death If No Inclusion Event
- > Deferred Gain Carried Over to Estate/Transferee
- > QOZ Fund Interest Generates Income in Respect of a Decedent (IRD)
  - – Basis in the QOZ Fund Interest will not be stepped-up to the extent of the IRD

Holding Period

- If gift is not considered an inclusion event, the holding period of a qualifying investment is "tacked" and includes the time during which a qualifying investment that was held by the donor
- In the case of death, the holding period of a qualifying investment is "tacked" and includes the time during which that qualifying investment was held by the deceased owner.
- In each case where there is tacking, the transferee steps into the shoes of the transferor with respect to the five-year, seven-year, and 10-year holding periods

Planning Opportunities

Planning Opportunities

> **Eleanor Entrepreneur sells her Artificial Intelligence business for $100 million in June 2019**
  – Gain That She Reinvests in QOZ Fund is Deferred Until 2026
  – As a Serial Investor Entrepreneur, She Can Reinvest Proceeds Into New Businesses Located in an Opportunity Zone
  – Avoid Gain on Sale of New Investment

Planning Opportunities

> **Oscar Oldmoney has a large concentration of very low basis tobacco stocks that have been in his family for many years.**
  - He is concerned that "vaping" and legalized marijuana will be a disruptive force and wants to diversify out of the tobacco stocks, but wants to minimize the resulting gain
  - Oscar can sell the tobacco stocks and defer gain until 2026 and reinvest in QOZ Fund assets
  - If Oscar dies before 2026, unreported gain is income in respect of a decedent and Oscar's heirs must pay tax at that time

Planning Opportunities

> **Fred Fiduciary is the Trustee of a Dynasty Trust with concentrated stock positions with very low basis**
  – Fred can sell the stocks and defer gain until 2026 and reinvest in QOZ Fund assets, thereby diversifying the trust portfolio
  – New investment in QOZ Fund not subject to capital gain tax

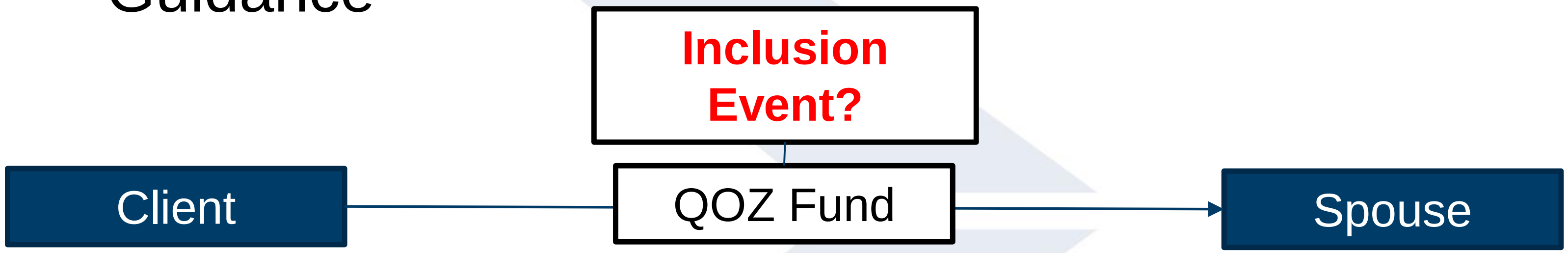
Planning Examples and Open Issues in the Regulations

Planning Examples

> **Client gifts QOZ Fund Investment to Child**
  – Inclusion Event

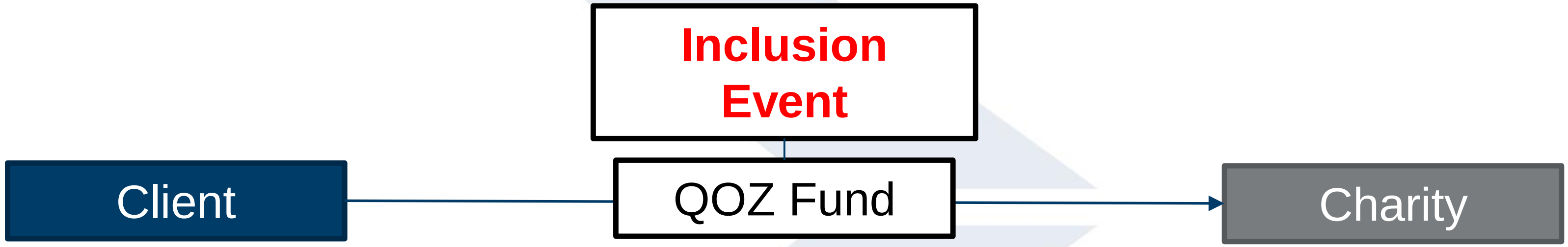
Planning Examples

> **Client gifts QOZ Fund Investment to Spouse**
  - Arguably an Inclusion Event
  - Does Code § 1041 Override? Need Additional Guidance



Planning Examples

> **Client gifts QOZ Fund Investment to Charity**
  – Inclusion Event



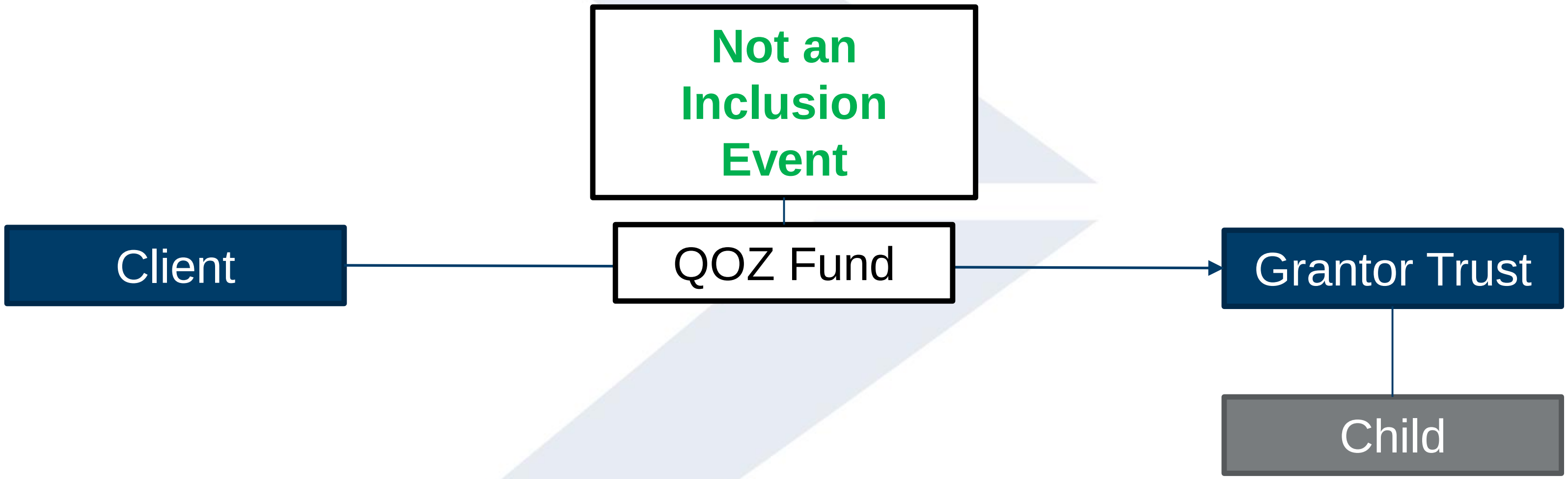
Planning Examples

> **For probate avoidance, Client transfers QOZ Fund Investment to Client's Revocable Trust (an incomplete gift to a grantor trust for income tax purposes)**

– Not an inclusion event

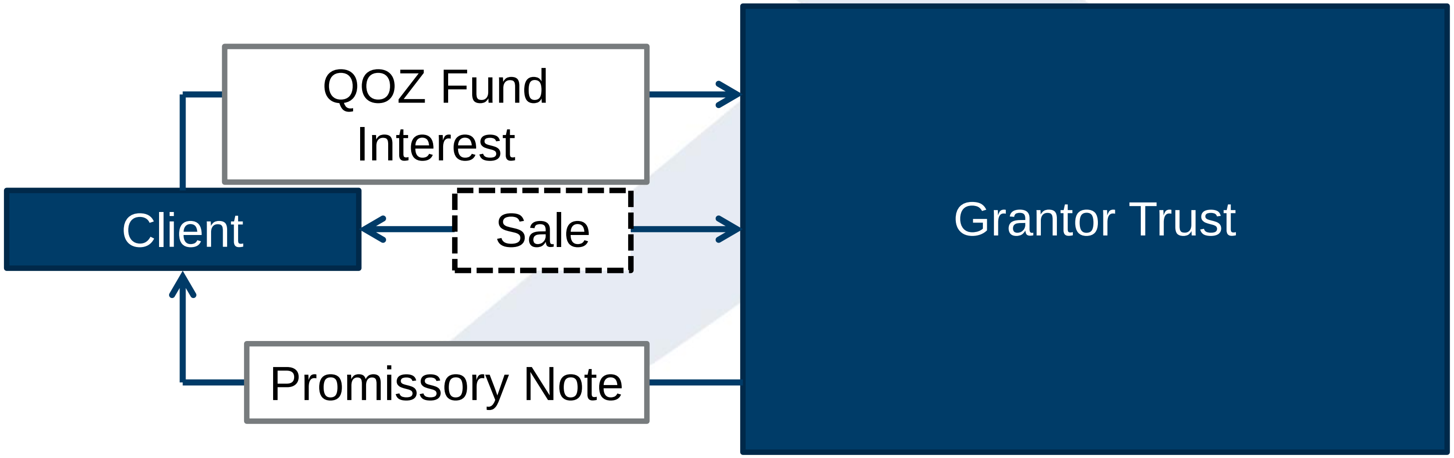
Planning Examples

> **Client gifts QOZ Fund Investment to Grantor Trust for Benefit of Child**
  – Not an inclusion event



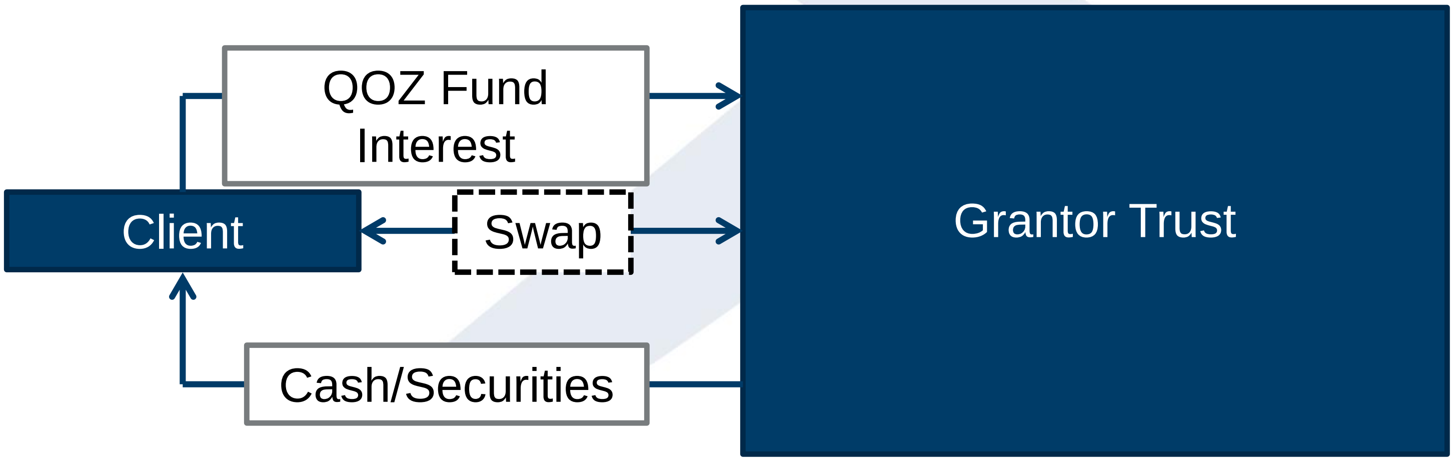
Planning Examples

- **Client sells QOZ Fund Investment to Grantor Trust for Child for note equal to FMV of QOZ Fund Investment**
  - Not clear - regulation provides that a "contribution" by the Grantor to Grantor Trust is not an inclusion event.
  - Is a "sale" the same as a "contribution?"



Planning Examples

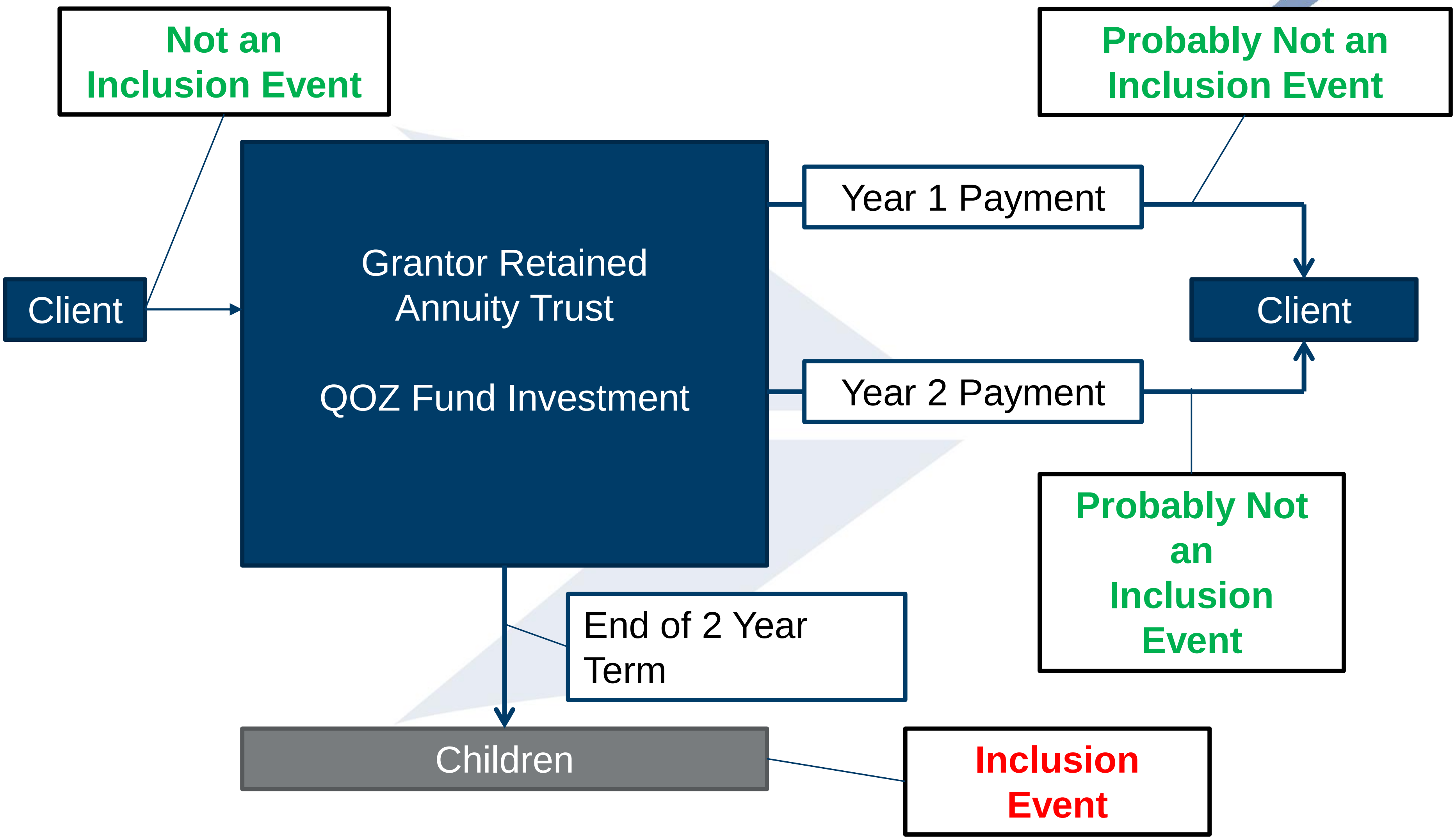
> **Client exercises Substitution Power under Code § 675 to "Swap" QOZ Fund Investment in (or out) of Grantor Trust for Assets of Equivalent Value**
  - Not clear
  - Is a "substitution" the same as a "contribution"?



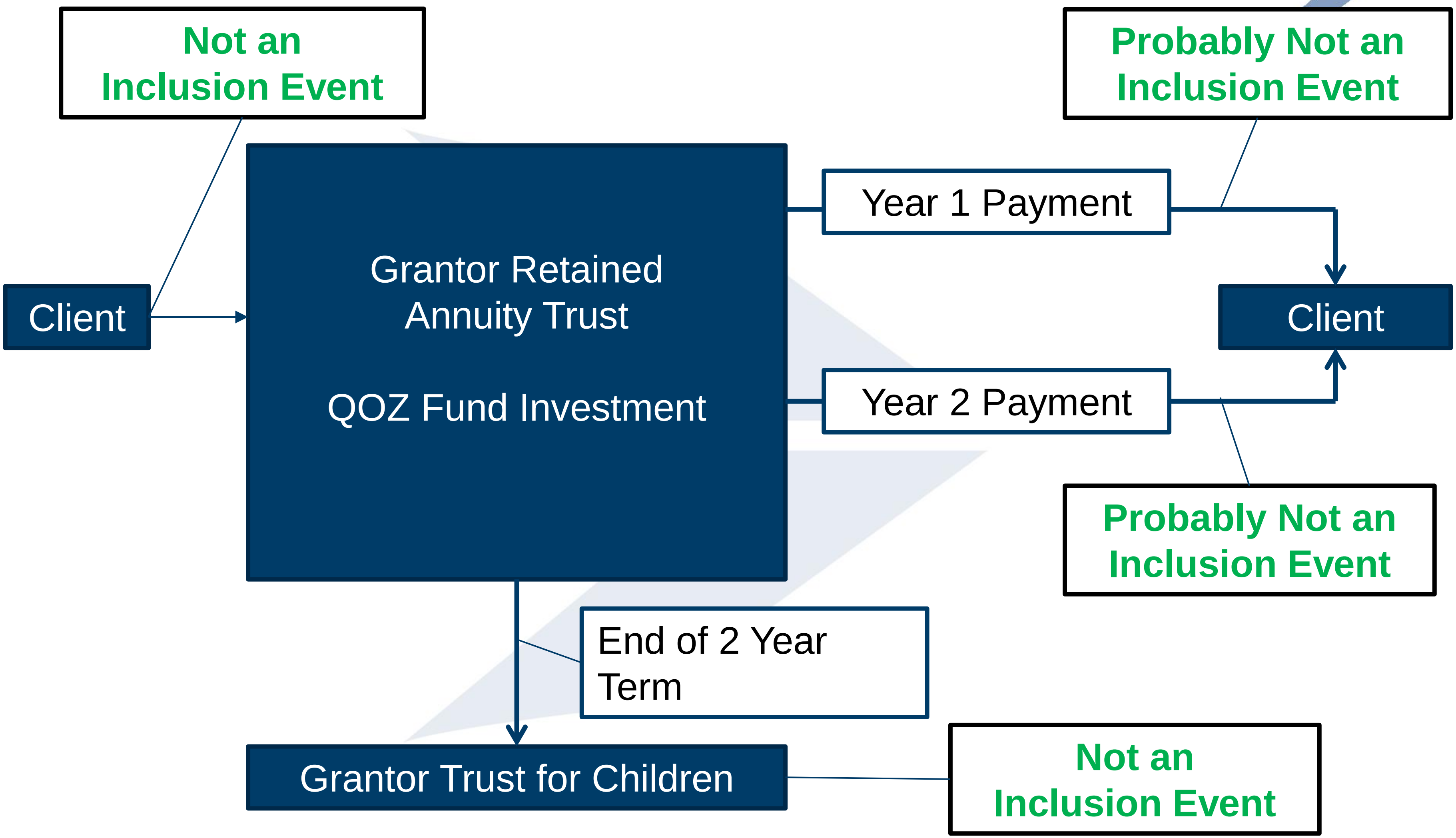
Planning Examples

> **Client gifts QOZ Fund Investment to GRAT for benefit of Child**
  - GRAT is a grantor trust during GRAT Term
    - Contribution is not an inclusion event
  - Is a distribution, in kind, from GRAT (a grantor trust) to Client an inclusion event?
    - Probably not, but not specifically addressed
  - Upon expiration of GRAT, if remainder passes outright to Child or to a non-grantor trust for benefit of Child, this is an inclusion event
    - Planning Pointer: Have GRAT remainder pass to continuing grantor trust for Child

Grantor Retained Annuity Trust

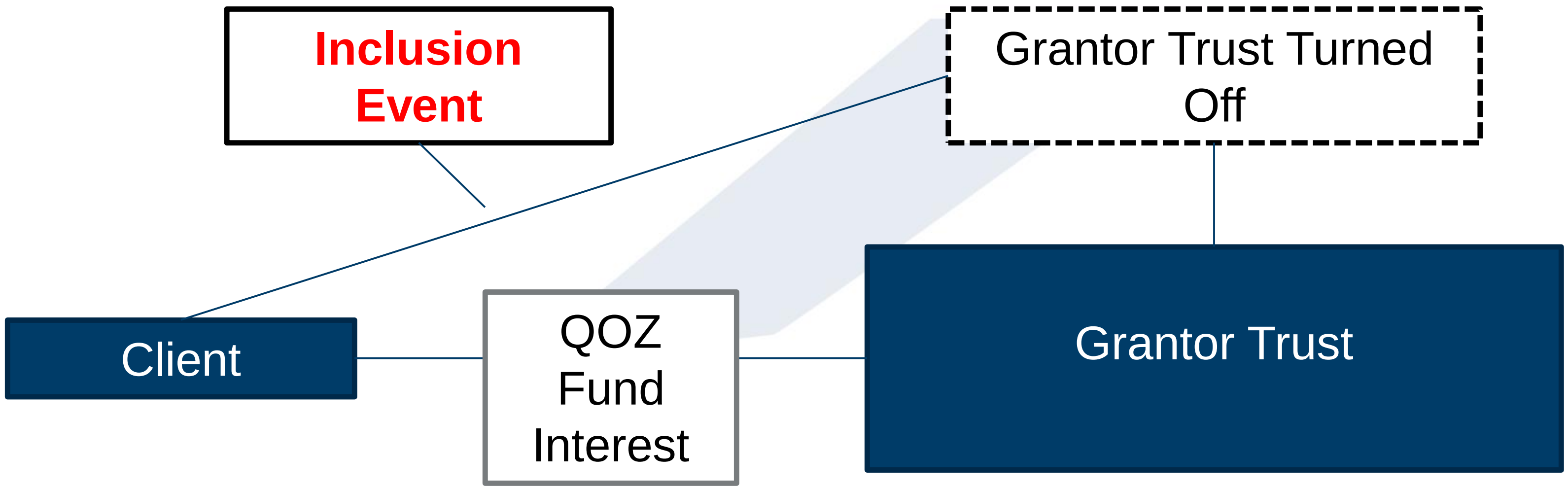


Grantor Retained Annuity Trust



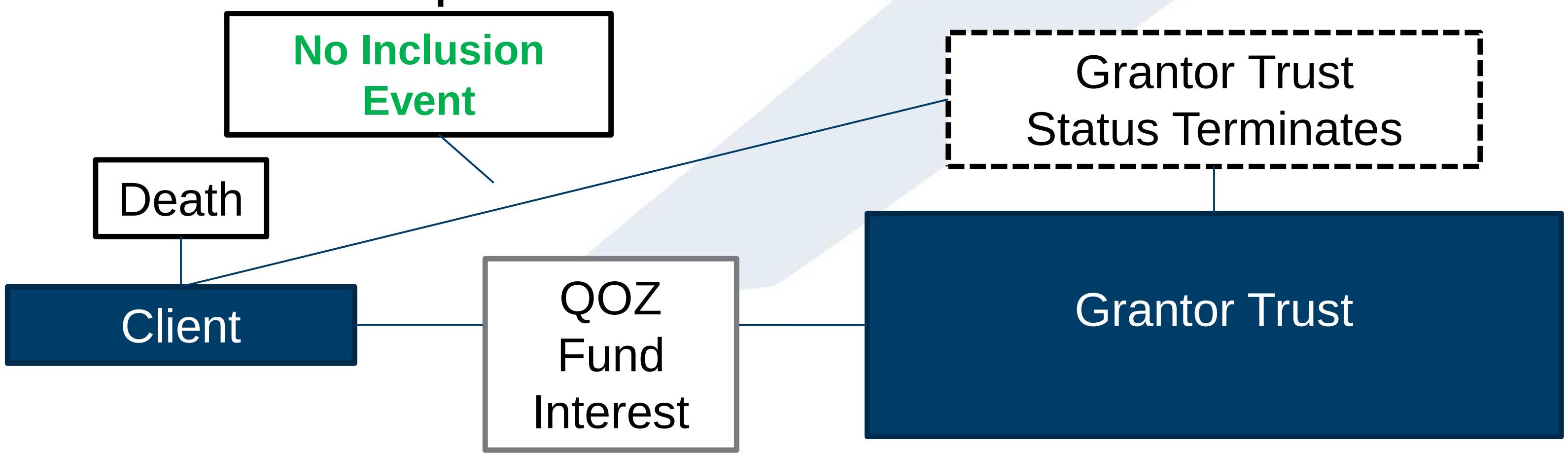
Planning Examples

> **Client gifts QOZ Fund Investment to Grantor Trust for Child**
  - Grantor Trust "turned off" during Grantor's lifetime
  - Inclusion event when "turned off"
    - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) (First Sentence)



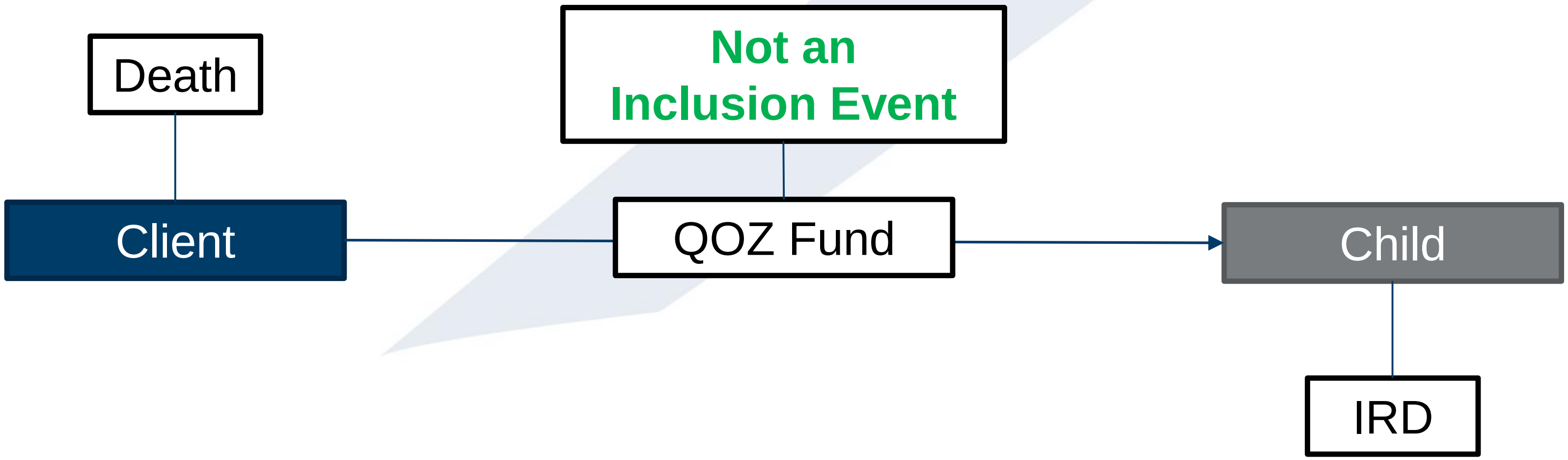
Planning Examples

> **Client gifts QOZ Fund Investment to Grantor Trust for Child**
  - Client dies, causing grantor trust status to cease
  - Not an inclusion event - Treas. Reg. § 1.1400Z2(b)-1(c)(5)(ii) (Second Sentence)
  - This appears to be a significant concession by the IRS on the question of whether death is a realization event



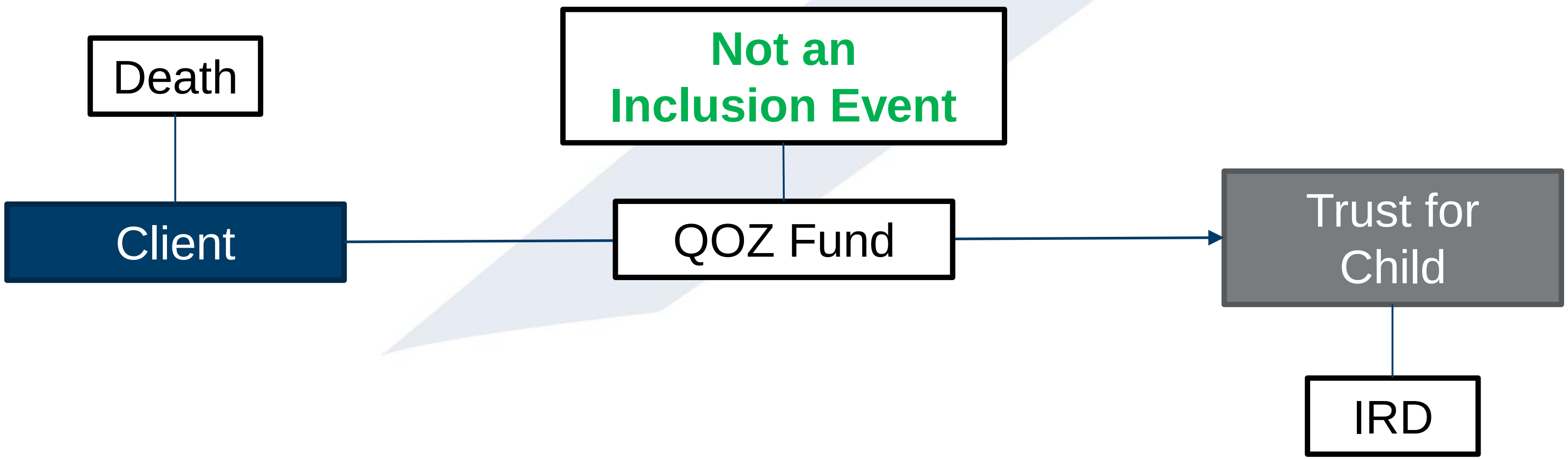
Planning Examples

- **Client dies and bequeaths QOZ Fund Investment to Child**
  - Not an inclusion event
  - Unpaid capital gain tax is income in respect of a decedent to Child, who must pay tax on deferred gain recognized as of 12/31/26



Planning Examples

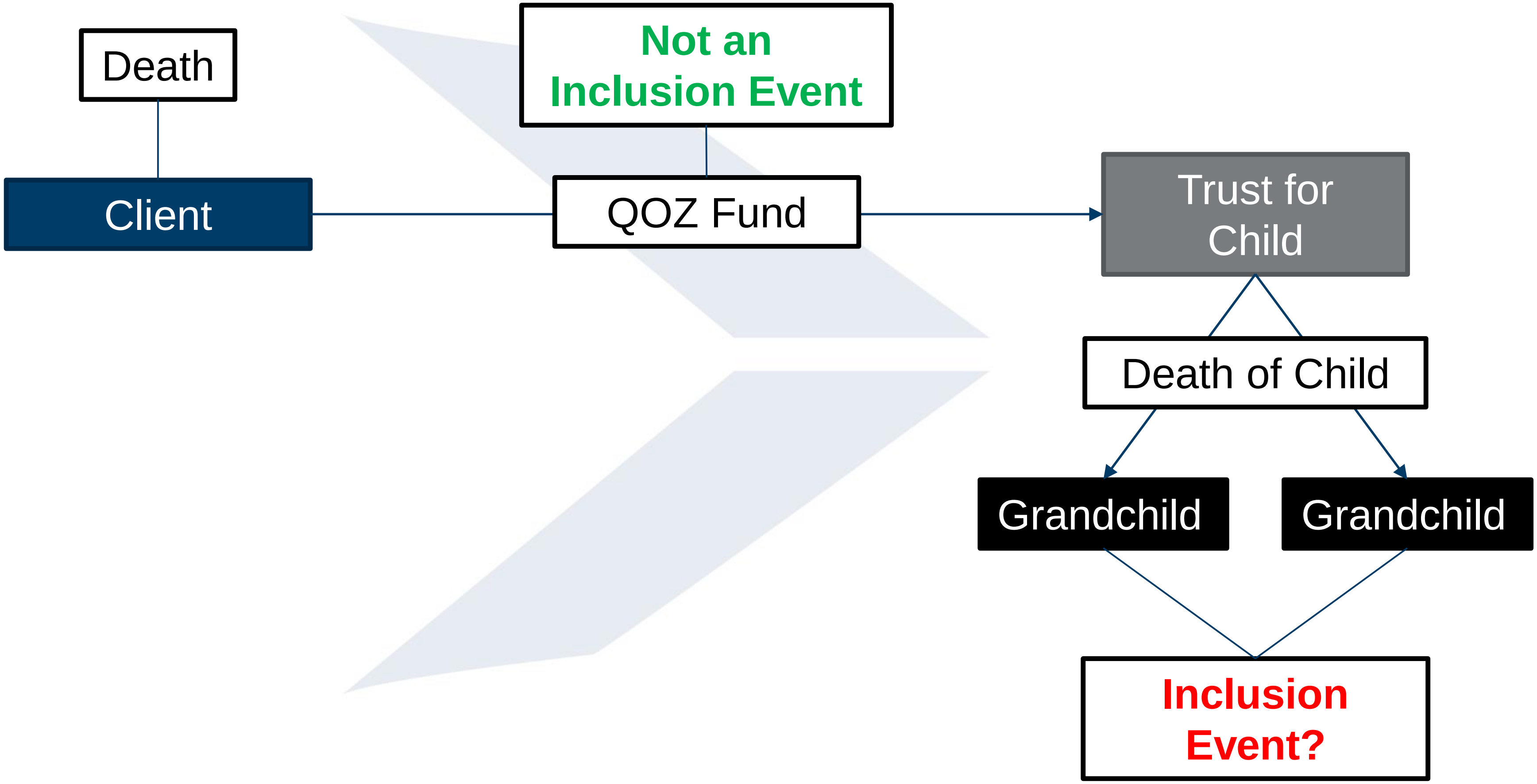
> **Client dies and bequeaths QOZ Fund Investment to Trust for Benefit of Child**
>
> – Not an inclusion event
>
> – Unpaid capital gain tax is income in respect of a decedent to Trust, which must pay tax on deferred gain recognized as of 12/31/26



Planning Examples

> **Same facts, but what happens if Trust subdivides at Child's death and is distributed outright to Grandchildren or to separate share trusts for Grandchildren**
  - Treas. Reg. 1-1400Z2(b)-1(c)(4)(i)(C) provides "A distribution of a qualifying investment by the deceased owner's trust that is made by reason of the deceased owner's death"
  - In this case, it is not the Client's death that is triggering the transfer, it is Child's death that is triggering the transfer
  - Consider using a "pot" trust

Planning Examples



Questions and Contact

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<u>Please note</u>: This presentation contains general, condensed summaries of actual legal matters, statutes and opinions for information purposes. It is not meant to be and should not be construed as legal advice. Individuals with particular needs on specific issues should retain the services of competent counsel.

Qualified Opportunity Funds and Opportunity Zones: What Estate Planners Need to Know

Fiduciary Issues & Investment Considerations

2019 ACTEC Summer Meeting
Business Planning Committee

Friday, June 28, 2019

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The views and strategies described herein may not be suitable for all investors and more complete information is available which discusses risks, liquidity and other matters of interest. This material is not intended to constitute a solicitation for the purchase or sale of any product or financial instrument.

Contents

Summary of Provisions Related to Gifts and Transfers at Death

Summary of Provisions Related to Gifts and Transfers at Death*

Outright Gift & Gift to Non-Grantor Trust	Gift to Grantor Trust	Bequest at Death
• "Inclusion event" (accelerates the recognition of deferred gains)	• Non-inclusion event	• Non-inclusion events: – Transfer to decedent owner's estate – Distribution by decedent owner's estate – Distribution by decedent owner's trust by reason of death – Jointly owned property passing by operation of law at decedent owner's death – Other property passing by operation of law at decedent owner's death
	• Termination of grantor trust status: – *By reason of grantor's death* – Non-inclusion event – *Other than by grantor's death* – Inclusion event (unless distributed to another grantor trust)	• Inclusion events: – Sale, exchange, or other disposition by the decedent owner's estate – Sale, exchange, or other disposition made following the decedent owner's death by the legatee, heir, or beneficiary – Disposition by the surviving joint owner who received the property by operation of law at the decedent owner's death
	• Non-inclusion events: Tacking of holding period is permitted	• Non-inclusion events: Tacking of holding period is permitted • Inclusion events: Results in recognition of Income with Respect to Decedent (IRD) under IRC § 691.

* This slide was initially prepared by Benetta Park Jenson for the 31st Annual RPTE National CLE Conference panel presentation on May 10, 2019, entitled, "Opportunity Zones Part II: Maximizing Return – Tax Benefits & Planning Opportunities," hosted by the Section of Real Property, Trusts & Estates of the American Bar Association.

Fiduciary Duties Relating to Investments

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- Duty of Obedience
- Duty of Care / Duty to Act as a Prudent Investor
- Duty of Loyalty
- Duty of Impartiality

Duty of Obedience

- Requires the fiduciary to carry out the terms of the trust, as established by the settlor.[1]
- Instructions may include, among other things, the investing and managing of assets
- Thus, if a settlor directs the trustee to invest in sustainable investments (QOFs are considered to be sustainable investments) or specifically in QOFs, then the trustee is bound by that direction, unless the trust is modified in an appropriate manner

1. Restatement (Third) of Trusts § 76 (2007).

Duty of Care / Duty to Act as a Prudent Investor

- Requires a fiduciary to act with "reasonable care" and incorporates the "prudent investor rule"
- Under the "Prudent Investor Rule," fiduciaries have a general duty to manage property as a prudent person would, bearing in mind the directions of the settlor and the interests of the beneficiaries
- General History of Fiduciary Investing and Prudent Investor Rule:
  - Modern Portfolio Theory
  - Restatement (Third) of Trusts & the Prudent Investor Rule
  - Uniform Prudent Investor Act (UPIA)

Duty of Care / Duty to Act as a Prudent Investor (continued)

Modern Portfolio Theory

- The “Efficient Portfolio”
- Risk is spread across an investment portfolio by taking into account how an asset’s return correlates to other assets in the portfolio, rather than making investment decisions made on an asset-by-asset basis
- Asset correlation and diversification are key elements to managing risk and improving returns

Duty of Care / Duty to Act as a Prudent Investor (continued)

Restatement (Third) of Trusts & the Prudent Investor Rule

- Prudent investor standard continues to evolve as investment strategies change:

  "[T]he rules must be general and flexible enough to adapt to changes in the financial world and to permit sophisticated, prudent use of any investments and courses of action that are suitable to the purposes and circumstances of the diverse trusts to which the rules will inevitably apply.[1]

1. Restatement (Third) of Trusts, Pt. 6, Ch. 17, Introductory Note (2007).

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- <u>Trustee Considerations - UPIA § 2(a)</u>: "A trustee shall invest and manage trust assets as a prudent investor would, by considering ***the purposes, terms, distribution requirements, and other circumstances of the trust***. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution."
- <u>Total Portfolio - UPIA § 2(b)</u>: "A trustee's investment and management decisions respecting individual assets must be ***evaluated not in isolation but in the context of the trust portfolio as a whole*** and as a part of an overall investment strategy having ***risk and return objectives reasonably suited to the trust***."

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Additional Factors - UPIA § 2(c): Circumstances that a trustee shall consider in investing and managing assets include but are not limited to:
  1. General economic conditions
  2. Possible effect of inflation or deflation
  3. Expected tax consequences of investment decisions or strategies
  4. Role of each investment in overall portfolio
  5. Expected total return from income and appreciation of capital
  6. Beneficiaries' other resources
  7. Needs for liquidity, regularity of income, and preservation or appreciation of capital
  8. Asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Typical Characteristics of Investments in QOFs:

1. Tax benefits of QOF investments held long-term
2. Long time horizon
3. Illiquid
4. Possible need for capital contributions
5. Need for payment of the deferred capital gains tax when due (earlier of exiting the QOF investment or December 31, 2026)
6. Cost of the investment in a QOF generally higher than other types of investments due to structure of the investment, due diligence, tax and reporting requirements (possible multiple K-1s), etc.
7. May have special value to the purposes of the trust, if the trust instrument permits or specifically references “qualified opportunity funds,” “sustainable investments,” “socially responsible investments,” etc.
8. May have special value to the one or more of the beneficiaries, if a beneficiary or beneficiaries have personal values or the desire to engage in sustainable investing strategies that align with the societal, environmental, governance or other values or beliefs of the beneficiary or beneficiaries

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Duty to Diversify - UPIA § 3: "A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, ***because of special circumstances, the purposes of the trust are better served without diversifying***."
- *Post* Case: In *Matter of the Trust of Ray D. Post*,[1] the New Jersey Superior Court held that a trustee breached its fiduciary duties by diversifying trust assets because the sale of those assets violated the grantor's express instructions to retain property originally transferred to the trust. Settlor intent is paramount and trumps the duty to diversify.

1. *Matter of Trust of Ray D. Post*, 2018 N.J. Super. Unpub. LEXIS 1932 (N.J. App. Div. Aug. 15, 2018).

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- <u>Duty of Loyalty - UPIA § 5</u>: "A trustee shall invest and manage the trust assets solely in the interests of the beneficiaries." This is opposed to a trustee acting for the trustee's own interest or that of third parties.
  - <u>Comments to UPIA § 5</u>: "No form of so-called ***"social investing"*** is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the beneficiaries -- ***for example, by accepting below-market returns*** -- in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause."
  - However, presumably, in order to receive the tax benefits from investing in a QOF, the investor is seeking above-market returns.

Duty of Care / Duty to Act as a Prudent Investor (continued)

Uniform Prudent Investor Act (UPIA)(continued)

- Reasonable Investment Costs – UPIA § 7: "In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."
- Cost of investments in a QOF generally higher than other types of investments due to structure of the investment, due diligence, tax and reporting requirements (possible multiple K-1s), etc.

Duty of Loyalty

- <u>Duty of Loyalty - UPIA § 5</u>: "A trustee shall invest and manage the trust assets solely in the interests of the beneficiaries." This is opposed to a trustee acting for the trustee's own interest or that of third parties.
  - <u>Comments to UPIA § 5</u>: "No form of so-called ***"social investing"*** is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the beneficiaries -- ***for example, by accepting below-market returns*** -- in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause." Emphasis added.
  - However, presumably, in order to receive the tax benefits from investing in a QOF, the investor is seeking above-market returns.

Duty of Impartiality

- Duty of Impartiality - UPIA § 6: “If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.”
- Different beneficiaries may have different values and desires to support an investment in a QOF.

Select Other Considerations and Practical Issues for a Trustee

Select Other Considerations and Practical Issues for a Trustee

- QOFs structured as indirect investments through funds typically are either single-asset funds or multi-asset funds. The QOF structure may affect how a Trustee invests and manages the QOF investment.

	SINGLE-ASSET FUND	MULTI-ASSET FUND
GENERAL STRUCTURE	• Single asset / project in a single entity	• Multiple assets / projects, each of which is held in a separate, parallel entity (*e.g.*, LLC) because fund-of-fund structure is prohibited
USE OF CAPITAL	• Front-loaded – capital raised and put to work quickly	• Elongated - capital raised and put to work over time
CONSIDERATIONS	• Concentration of investor's capital – concentration risk but may be easier to structure and operate • Easier for investor to match with 180-day period for investment of capital gains • Easy for investors with large realized gains who need to quickly identify a suitable QOF within 180 days of realization	• Diversified portfolio but more complicated structure • Multiple capital calls during life of fund and harder to match each capital call with 180-day period for investment of capital gains (higher likelihood of a "mixed investment") • Better for investors who have large unrealized gains but have control over gain realization timing or have rolling, dependable gains (*i.e.*, have reasonable certainty/predictability of expected gains)

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Select Other Considerations and Practical Issues for a Trustee (continued)

- Paying the Tax in 2026: In 2026, taxpayers will need to pay the deferred capital gains tax on the original capital gains and they should have a plan to pay.
  - Conservative approach: Pay the deferred capital gains tax using outside assets.
  - Distributions from a QOF: Some QOFs plan on making distributions to the investors so investors can pay the deferred capital gains tax. But distributions from QOFs would constitute an inclusion event to the extent the distributions exceed a taxpayer's basis.

Select Other Considerations and Practical Issues for a Trustee (continued)

- Combining QOZ Tax Benefits with Other Tax Benefits: It is possible for a QOF to claim income tax credits and other tax benefits. However, further guidance is needed on the interaction among the QOZ rules and other tax provisions (*e.g.*, IRC § 45D new markets tax credit, IRC § 42 low-income housing tax credit).
  - Example - IRC §§ 1202 and 1045 Qualified Small Business Stock (QSBS) Exclusion and QSBS Rollover
    - Take QSBS exclusion from capital gains upon sale of QSBS shares and then use the excess capital gain above the QSBS exclusion that would be recognized to either (1) roll over into another QSBS investment under IRC § 1045 (which also could be a QOF) or (2) invest in a QOF.

Drafting Considerations

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New Trust

- When a client is creating a new trust and is interested in the trust being able to invest in and hold investments in QOFs or sustainable investments, the trust should be designed to be flexible to accommodate those investments, however those investments may be structured (*e.g.*, direct investment or indirect funds).
  - <u>Settor's Intent & Trust Purpose</u>: Expressly state that the purpose of the trust is to invest with a sustainable lens (*e.g.*, that the trustee may invest taking into account the revitalization of distressed communities) and authorize the trustee in making investment decisions taking this purpose and the settlor's wishes into account.
  - <u>Directed Trust Language</u>: Build flexibility into the trust instrument by including directed trust provisions.
  - <u>Flexibility to Make Administrative Changes to the Trust</u>: Provide flexibility in the trust instrument to change the administrative provisions of the trust, if needed to carry out the settlor's intent for the trust to make investments in QOFs or sustainable investments (*e.g.*, change of situs and governing law provisions, trust protector provisions with the power to modify the administrative provisions of the trust and/or achieve the purpose of the trust or for tax advantages, other ways to modify the trust).

Drafting Considerations

Existing Trust

- If it is unclear whether the trust instrument permits investments in QOFs:
  - Clarify the Existing Trust (using judicial construction, non-judicial settlement agreement, or non-judicial consent agreement)
  - Modify the Existing Trust (using powers of appointment, judicial reformation, judicial modification, non-judicial settlement agreement, non-judicial consent agreement, decanting, merger)

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