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Creative Trust Planning for Real Estate Developers

Learn about tax-advantaged trust strategies under today's tax laws

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Key points

- Tax reform passed in 2017 created major changes and opportunities for high-net-worth taxpayers, particularly real estate developers
- Planning for the ultimate continuation or sale of your business is as important as growing your business
- From a strategic planning perspective, real estate developers may want to consider targeted trust strategies

As a real estate developer, you may be in a favorable income tax position because of the nature of your business and the assets you employ in that business. Assets such as depreciable buildings, depreciable construction machinery and equipment, as well as other business assets, may provide income tax deductions that effectively shelter much of your income. These income tax benefits may be realized by you as a sole proprietor of your development business or as an owner of various pass-through entities, such as partnerships or limited liability companies that hold your real estate development assets.

Let's take a look at today's current tax laws and then we'll explore some specific strategic planning opportunities using trusts that may be of value to real estate developers.

For 2024, the estate, gift, and generation-skipping transfer (GST) tax is still historically high at $13.61 million for individuals and $27.22 million for married couples. There are still seven individual tax brackets, with a top rate of 37%. The standard deduction is currently $14,600 for individuals and $29,200 for married couples. In addition, the corporate tax rate today sits at 21%*.

Many of the provisions of the current tax law affecting individuals are scheduled to sunset after December 31, 2025, at which time the prior provisions of the tax law would return if no further legislative action is taken*.

The features of section 199A

Under current law, there is a deduction for non-corporate taxpayers under Internal Revenue Code (IRC) section 199A. The section applies to income earned through partnerships, S corporations, LLCs (taxed as a partnership), and sole proprietorships, and provides a deduction of up to 20% of qualified business income (QBI). The definition of QBI can be rather complex, but for the real estate industry, it includes income from real estate development, leasing, and operations. QBI does not, however, include capital gains

*Source: www.irs.gov.

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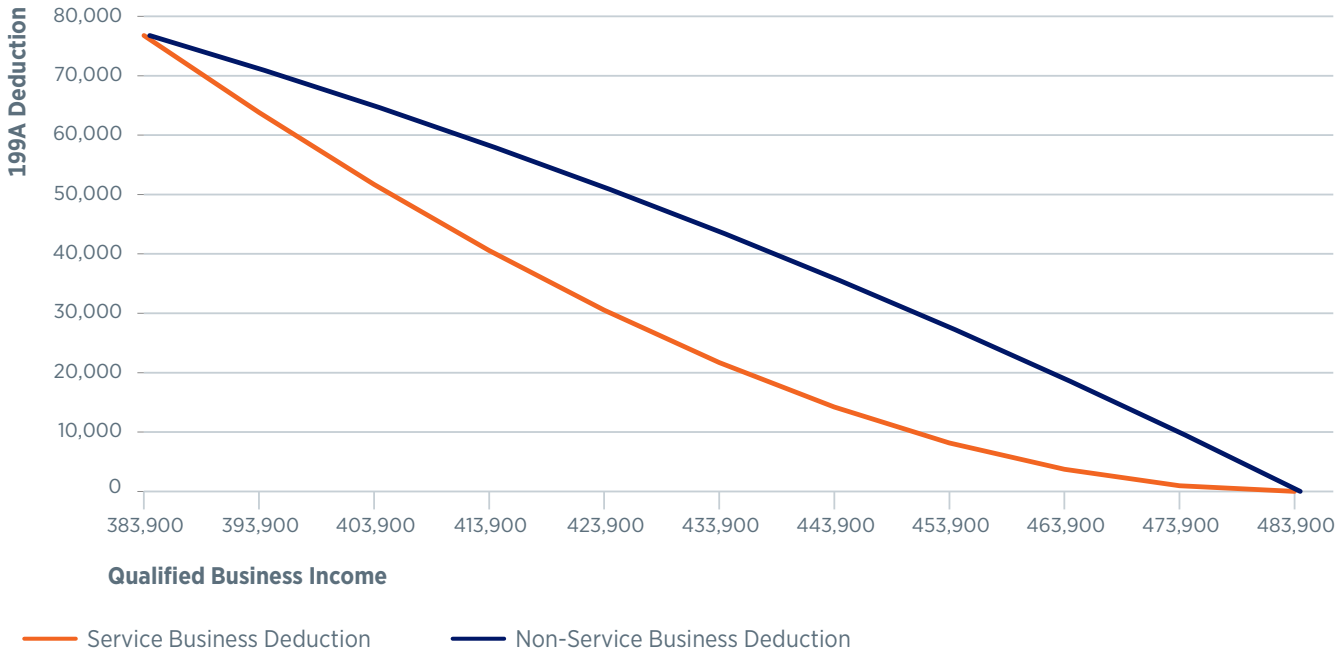
Figure 1

Detailed 199A phase-out illustration



Sources: Wilmington Trust Wealth Planning; www.bradfordtaxinstitute.com.

Note: This illustration assumes 2024 phaseouts, married filing joint, and no other income or deductions.

income, which is important for real estate developers, since this means the QBI calculation may not include gains from the sale of real estate.

Interest deduction limits

Beginning in 2018, the annual deduction for business interest expenses was limited to the sum of: 1) The taxpayer's business interest income for the tax year; 2) 30% of adjusted taxable income for the tax year; and 3) Floor plan financing interest for the year. For S corporations, partnerships, and LLCs treated as partnerships, the interest limitation applies at the partnership level. Any deduction not allowed for a taxable year may be carried forward indefinitely. However, it is important to note that this limitation does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, acquisition, rental, operation, management, or leasing if the taxpayer makes an election. The trade-off is that the taxpayer must utilize the alternative depreciation system (ADS) to depreciate any non-residential real property, or qualified improvement property. This limitation also does not apply to taxpayers whose average annual gross receipts for the prior three tax years did not exceed $29 million in 2023. For this calculation, related entities will be aggregated. (All data sourced from www.irs.gov.)

Enhanced cost recovery provisions

For qualified property placed in service after September 27, 2017 and before January 31, 2023, there was a temporary allowance for 100% bonus depreciation. Beginning in 2023, this bonus depreciation was phased down to 80% for property placed in service in 2023. The bonus depreciation will continue to be phased down to 60%, 40%, and 20% for property placed in service in 2024, 2025, and 2026, respectively. (Source: www.irs.gov.) Qualified depreciable property includes property with an applicable modified accelerated recovery system (MACRS) recovery period of 20 years or less, water utility property, certain computer software, and qualified improvement property. This qualified improvement property is defined as any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the building is placed in service (not including an escalator, elevator, an improvement to the internal structural framework, or an improvement to enlarge the building). It is critical to note that bonus depreciation will not be available for real estate trades or businesses that choose to elect out of the net interest deduction limitation previously described.

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High-net-worth taxpayers and business owners alike are faced with not only myriad changes, but also planning opportunities.

In addition, the expensing provision in Internal Revenue Code section 179 allows taxpayers to write off up to $1.22 million in 2024 of qualifying property put in service, and increasing the phase-out threshold to $3.05 million in 2024. This is particularly of interest to real estate developers because the definition of section 179 property has been expanded to include certain depreciable tangible personal property used primarily to furnish lodging as well as to include improvements made to nonresidential real property: roofs, heating, ventilation, air conditioning, fire protection, and alarm and security systems. It's important to understand that you must have net income to take section 179 expensing, and cannot create a loss by using it.

Exchanges of real property still allowed

While Internal Revenue Code section 1031 like-kind exchanges are now limited, the exchanges of real property are still allowed. These exchanges allow real estate developers to defer the recognition of taxable gains on the sale of their real property by replacing it with another piece of like-kind real property. By exchanging one piece of property for another, the taxpayer may carry over the basis, effectively carrying over the gain from the old parcel into the newly acquired one. This roll over of tax basis continues indefinitely until the taxpayer disposes of a piece of real estate without replacing it. At that time the taxpayer will recognize a gain on the disposition. An important caveat is that real estate held primarily for sale to customers is not eligible, which may affect condo developers. Additionally, any portion of the real estate that includes personal property may no longer get like-kind treatment.

Utilizing creative trust strategies

Taking advantage of today's high federal exemption to fund or add to trusts

With the significantly high federal exemption, high-net-worth taxpayers are afforded an opportunity to shift more of their current wealth (and potential future growth on any transferred assets) to their heirs free of federal transfer taxes. Large potential growth in the value of a real estate development business through successful operations, increases in real estate values, inflation, and other factors often indicates the need for estate freezing and minimizing strategies. These strategies are designed to limit or potentially reduce the value of the taxable estate, so that possible appreciation can be shifted over to beneficiaries free of gift, estate, and GST taxes. When transferring real estate, consider placing the real estate in an LLC before gifting interests into a trust for more efficient gifting. By utilizing an LLC structure, owners may afford themselves of lack of control and lack of marketability discounts to remove more value from their estates.

A dynasty trust established in a trust-friendly state, such as Delaware,* can be a good vehicle for such transfers. This trust is designed to help work toward achieving multigenerational tax savings, creditor protection, and flexibility. Also, by using a technique of selling appreciating assets to the trust in return for a promissory note, the federal exemption can be further leveraged to potentially mitigate future federal transfer taxes.

Using trusts to take full advantage of the section 199A deduction

Like many other deductions, section 199A's benefit may be limited because of an income threshold. In order to take full advantage of the deduction, real estate developers may want to consider utilizing trusts to spread the income to multiple taxpayers. By transferring ownership interests into non-grantor trusts, the real estate developer (as the grantor of

* Note that a few states, including Delaware, have special trust advantages that may not be available under the laws of your state of residence, including asset protection trusts and directed trusts.

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the trust) is effectively creating additional taxpayers to be owners of the business, each with their own 199A deduction and income threshold. To implement this strategy, the grantor would want to establish voting and non-voting interests in the business, and would then establish non-grantor trusts for the benefit of a spouse, children, and/or grandchildren to hold the non-voting interests. Each trust would be entitled to its own qualified business interest deduction. If the trust's income approaches the phase-out threshold, the trustee could determine if it makes sense to distribute the excess income to the trust's beneficiary, to be taxed at the beneficiary's individual tax rate, rather than the trust tax rate. For a spousal trust, any distributions would require approval of an adverse party. When considering this strategy, it's important to be sure that the grantor does not unintentionally enact IRC section 643(f), which treats multiple trusts established by the same grantor for substantially the same trust beneficiary as a single trust. Because of these nuances, it's imperative to consult with an advisory team including tax, legal, and wealth management professionals.

Funding Irrevocable Life Insurance Trusts to provide liquidity

Having sufficient available funds in the estate with which to pay monetary bequests, taxes, administration expenses, debts, and other obligations after death is an important planning consideration. The need for estate liquidity is often generated by the nature of real estate development business assets which may not be readily convertible into funds needed by an executor to meet estate obligations. This may necessitate the need for life insurance for liquidity needs.

The advantage of owning life insurance in an irrevocable trust, compared to personally owning the life insurance, is that the death benefit may not be included in the estate for estate and inheritance tax purposes. Without utilizing a trust, the death benefit may be includable in the estate and an estate tax liability could be potentially compounded.

Integrating deferral provisions and new like-kind exchange rules with trust planning

There are two capital gains tax deferral or mitigation strategies for real estate developers. In addition to the better known section 1031 exchanges, real estate developers have an additional option for deferring and potentially eliminating capital gains by investing in an Opportunity Fund. Investors are allowed to roll unrealized gains into an Opportunity Fund to defer federal taxes on the profit. Additionally, the character of the gain is irrelevant. The longer the investment stays in, the better tax benefit an investor receives. The taxpayer's initial basis in the Fund is zero, but the basis will be increased by 10% of the deferred gain after five years and 15% after seven years. If the investment remains in the Fund for at least 10 years, the individual will not recognize capital gains on the appreciation. The deferred gain must be recognized at the earlier of the date of sale of the investment or 10 years. For real estate developers looking for this long-term investment, owning the Opportunity Fund within a multigenerational dynasty trust makes sense because of the long-term mindset coupled with the attractive tax benefit. It is important to note that the basis adjustment tax benefit only applies to existing Opportunity Fund investors and is no longer applicable to new Fund investors. (Source: www.irs.gov.)

Decant trusts to provide more flexibility for tax basis management

For real estate developers who already have an irrevocable trust in place, it's important to take a look at the provisions of the trust to be sure it still meets its original objectives and is flexible to meet future needs. If the trust is older and can't adapt to changing environments, decanting it to provide more flexibility for tax basis management may be worth considering. Decanting involves distributing assets from an old irrevocable trust into a new irrevocable trust with slightly modified terms.

Tax basis management is an important component in a trust. While assets transferred at death generally enjoy a basis stepped up to the date of death value, assets within an irrevocable trust do not. As such, the estate tax impact of retaining certain assets within a trust should be balanced against the future income tax effects of the sale of such assets. It's important to build in flexibility at both the grantor's death as well as a beneficiary's death.

With the many changes and opportunities available under today's tax laws, it's important to consult with your advisory team to be certain your real estate investments and your personal wealth plan are working in an integrated and advantageous way.

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Don serves as president of Wilmington Trust's Emerald Family Office & Advisory group, which provides a robust platform of strategic advisory services and solutions for successful executives, entrepreneurs, and their families. The Emerald team guides clients in the creation, implementation, and execution of complex financial, estate, and succession plans.

A respected thought leader, Don is a Fellow of the American College of Trust and Estate Counsel (ACTEC), a highly selective group of peer-elected trust and estate attorneys in the U.S. and abroad. He has been an adjunct professor of law for close to 20 years and lectures frequently at industry-leading conferences, including the Heckerling Institute of Estate Planning.

Don's past experience includes the private practice of law and active duty service as Judge Advocate in the United States Army. He earned his undergraduate degree from Villanova University and his law degree from New England Law, Boston. He holds a master of laws degree in taxation from Temple University Beasley School of Law and a master of arts degree in theology from St. Charles Borromeo Seminary. Don serves on the board of directors of Philly VIP, a nonprofit legal assistance program. He also serves his community as an ordained deacon in the Archdiocese of Philadelphia.

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Marguerite serves as chief operating officer of Wilmington Trust's Emerald Family Office & Advisory, which provides a robust platform of strategic advisory services and solutions for successful executives, entrepreneurs, and their families. The Emerald team guides clients in the creation, implementation, and execution of complex financial, estate, and succession plans.

In her role as national director of Family Legacy Strategies for Emerald, Marguerite is responsible for the development and delivery of strategic advice offerings that provide personal wealth planning to high-net-worth individuals and their families through the design and implementation of their estate, business succession, and family legacy plans. She oversees a national team of wealth planners, analysts, and family legacy advisors.

Prior to joining Wilmington Trust, Marguerite was an associate in Pricewaterhouse-Coopers' personal financial services group in their Philadelphia office. She holds a JD and master of laws (LL.M.) in taxation from Villanova University's Charles Widger School of Law and earned her bachelor's of science and bachelor's of arts degrees from the University of Maryland, College Park.