

New York State Bar Association Tax Aspects of Real Property Transactions

Estate Planning for Investment Real Estate: Don't Forget the Income Tax Side

By Stephen M. Breitstone, Esq.

**Meltzer, Lippe, Goldstein & Breitstone, LLP
Mineola, New York**

sbreitstone@meltzerlippe.com

[www. Meltzerlippe.com](http://www.Meltzerlippe.com)

Comparison of Rate

- Different Tax Base (Federal)
 - Estate Tax 40% Net Equity
 - Income Tax 20-39.6% of Gain
- Amount realized includes nonrecourse debt
- Lifetime planning can sacrifice basis step up to save estate and gift taxes – may not be a good tradeoff.

COMPARISON OF FREEZE TECHNIQUES

- Grantor Retained Annuity Trusts (GRATs)
- Installment Sale to Intentionally Defective Grantor Trusts (IDGTs)
- Partnership and LLC Freezes under Section 2701

FREEZE TECHNIQUES (cont.)

- GRATs –
 - Zero valuation risk – annuity self adjusts to FMV
 - Low Section 7520 hurdle rate (Sept. 2013 – 1.98%)
 - Can “zero” out
- But pitfalls:
 - Must survive term to avoid inclusion
 - Cannot allocate GST exemption until expiration of GRAT term when ETIP ends
 - Termination of Grantor trust status can trigger income taxes – especially when negative capital
 - During lifetime, may result in gain recognition
 - Upon death, basis step up may be unavailable

FREEZE TECHNIQUES (cont.)

- Installment Sales to IDGTs –
 - Lowest rate (AFR)(Sept. 2013, ST .25%; MT 1.64%; LT 3.2%)
 - Difficulties with valuation
 - But courts are becoming receptive to valuation clauses
 - Risky if property depreciates
 - Can maximize leverage and allocated GST exemption to initial gift (if there is one)
 - Note included in estate will not qualify for 6166 deferral
 - Most likely to result in NYC and NYS transfer taxes
 - Termination of Grantor trust status income tax
 - May result in gain recognition
 - Basis step up upon death uncertain

FREEZE TECHNIQUES (cont.)

- Freeze Partnerships under Section 2701
 - Highest hurdle rate (preferred return) determined by market forces (See, e.g., Rev. Rul. 83-120)
 - Gain upon formation not dependent on use of IDGT
 - (Junior equity to be held by IDGT)
 - Basis step up on death of grantor for negative capital is assured to the extent liabilities are allocated to Senior
 - NYS and NYC transfer taxes upon formation unlikely

Rev. Rul. 83-120 guidelines for valuing preferred interest in closely held business entities (Fair Market Value based upon Facts and Circumstances).

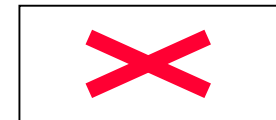
Factors:

1. Yield
2. Preferred return coverage
3. Dissolution protection
4. Apparently lesser, but not immaterial, weight to voting rights (e.g. voting control) and lack of marketability
5. Current market conditions
6. Underlying risk profile of the PLP assets and preferred rate coverage
 - (a) Volatility
 - (b) Income production (actual or through unitrust contributions)

Preferred Stock Returns in the Market

• Hotels	7.32% to 10.93%	Median	– 8.96%
• Retail	6.81% to 9.97%	Median	– 8.09%
• Multi -Family	6.64% to 8.22%	Median	– 8.08%
• Office	7.01% to 8.45%	Median	– 7.73%

Market data courtesy of Anchin LLC



FREEZE TECHNIQUES (cont.)

- Freeze Partnerships under Section 2701
 - Must weigh higher hurdle rate v. basis step up on negative capital

Liabilities in Excess of Basis (a/k/a Negative Capital)



What is this Negative Capital?

Is it logical?

Liabilities in Excess of Basis (Cont.)

- Depreciation + Refinance = Negative Capital
- Negative capital results in phantom gain = tax liability with no cash to pay



Liabilities in Excess of Basis (Cont.)

- Tufts v. Commissioner, 461 U.S. 300 (1983)(codified in section 7701(g))
- IRC section 7701(g)(in determining gain or loss, fair market value of property is deemed to be not less than the nonrecourse liabilities to which the property is subject)

Liabilities in Excess of Basis Illustrated

AB Partnership

Assets

Real Estate(fmv)	\$10,000,000
Real Estate (adjusted basis)	\$ 1,000,000

Liabilities

Mortgage	(\$ 8,000,000)
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Capital

Equity (cash proceeds from a sale)	\$ 2,000,000
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Gain Subject to Taxation (\$ 9,000,000)

Tax on Gain if Real Estate is Sold For \$10,000,000

Tax @ 20% \$ 1,800,000

Tax @ 25% \$ 2,250,000

Add State and Local Taxes and 3.8% Obamacare tax

Assuming 35% overall rate tax is \$3,150,000

Grantor Trust Authorities

- IRC section 671 and Treas. Reg. 1.671-3(a)(1) – requires the grantor to include all items of income, deduction, and credit of the trust as though the trust were not in existence during the period the grantor is treated as the owner.
- Rev. Rul. 85-13, 1985-1 C.B. 184 - For income tax purposes no sale is deemed to occur as long as the trust remains a grantor trust.

GRANTOR TRUSTS (Cont.)

- Grantor trusts and negative capital do not mix well
 - Termination of grantor trust status during lifetime of grantor can trigger gain
 - Negative capital
 - Outstanding installment obligations

Termination of GT Status upon the Death of the Grantor (Cont.)

- Does death cause gain recognition on negative capital?

- See Crane v. Commissioner, 331 U.S. 1 (1947)(often cited for the proposition that death is not a event that triggers gain)

- See CCA 200923024 (stating “We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the ***death of the owner which is generally not treated as an income tax event***”)

Termination of GT Status upon the Death of the Grantor

- Does termination of GT status on death cause a basis step up? Under section 1014?; Section 1012?
 - See Crane v. Commissioner, 331 U.S. 1 (1947)(property acquired from decedent subject to nonrecourse debt equal to the FMV of asset; IRS argued no step up under predecessor to 1014; Court found step up and analogized to a sale subject to debt)
 - This case has been argued to provide for a basis step up under either section 1014 (assets included in estate) or section 1012(property purchased subject to debt)
 - See CCA 200937028 (no basis step up under 1014 unless asset is included in the decedent's estate)

Termination of GT Status upon the Death of the Grantor (Cont.)

- Is it too much to ask?
 - Grantor does not pay tax on gain – ever
 - Asset not included in estate if held by trust so no estate tax
- Should client's take the risk if there is an alternative?

Obama Proposals are Game Changers for Grantor Trust Planning

- Proposals would treat transfers to grantor trusts as incomplete gifts
- This forces a choice between grantor trust status and estate tax inclusion
- Planning with grantor trusts would be curtailed
- Leveraged planning for values in excess of exemptions would be severely curtailed
- Proposals to apply to grantor trusts formed prospectively

Elements of the Freeze Partnership

- There are typically two classes of partnership interest:
 - Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).
 - Junior equity interest, which is entitled to growth and appreciation (like common stock).
 - (a) The preferred interest is typically retained, and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer.

Elements of Section 2701

- Is there a transfer? Capital contribution, reorganization, etc.
- Is it to or for the benefit of a “member of the family”? See Treas. Reg. Section 25.2701-1. (generally, of an equal or lower generation)
- Did the Transferor (or “applicable family member”; generally of an equal or higher generation) retain an “applicable retained interest”?
- “Applicable Retained Interest” means
 - distribution rights in family controlled entity; or
 - liquidation, put, call or conversion right.

Elements of Section 2701 (Cont.):

- Zero Value Rule:
 - If there is a “transfer” the retained interest will be valued at zero for gift tax purposes unless the transferor retains
 - a “Qualified Payment Right”; or
 - a liquidation, put, call or conversion right.

Elements of Section 2701 (Cont.):

- Straight Up Allocation Exception to Zero Value Rule –
 - All Membership Interests are of the Same Class
 - All Allocations are Straight up
 - Differences in Voting Rights are Permitted
 - Differences in Liability Permitted (e.g., GP v. LP)
 - Marketable Securities can be of a Different Class.
 - Vertical Slice for Fund Managers

Elements of Section 2701 (Cont.):

- Qualified Payment Rights are periodic (at least annual) cumulative fixed payment rights.
 - Qualified payment rights are valued according to fair market value (FMV).
 - Lower of Rule: If a qualified payment right is held along with an extraordinary payment right the rights are valued as if each was exercised in the manner resulting in the lowest value for all such rights.
- Four Year Rule: Any payment of a qualified payment made (or treated as made) either before or during the four-year period beginning on the due date of the payment but before the date of the taxable event is treated as having been made on the due date.

Entity Level Valuation - Family Matter:

The 2701 Regulations promulgated in 1992 provide that all family owned interests are valued as if held by a single person:

- Exception for Capital Contributions. *See*, Treas. Reg. 25.2701-3(b)(1)(i).
- Contrast Rev. Rul. 93-12 (recognizing intra family valuation discounts).
- Unless 100% family owned, lack of marketability discounts should apply regardless of 1992 Regulations.

Subtraction Method

Deemed Gift is determined as follows:

- Step 1 - value all family-held interests as if held by one person (except capital contributions).
- Step 2 - subtract the value of senior equity interests (as if held by one person).
- Step 3 - allocate the remaining value among the transferred interests and other family-held subordinate equity interests.
- Step 4 - apply certain discounts and other reductions as provided for by Treas. Reg. 25.2701-3(b)(4);
Treas. Reg. 25.2701-3.

Subtraction Method (Cont.)

- Minimum Value Rule:

Junior equity interests cannot be valued at less than 10% of:

- a) the total value of all equity interests in the entity, and
- b) the total amount of indebtedness of the entity to the transferor.

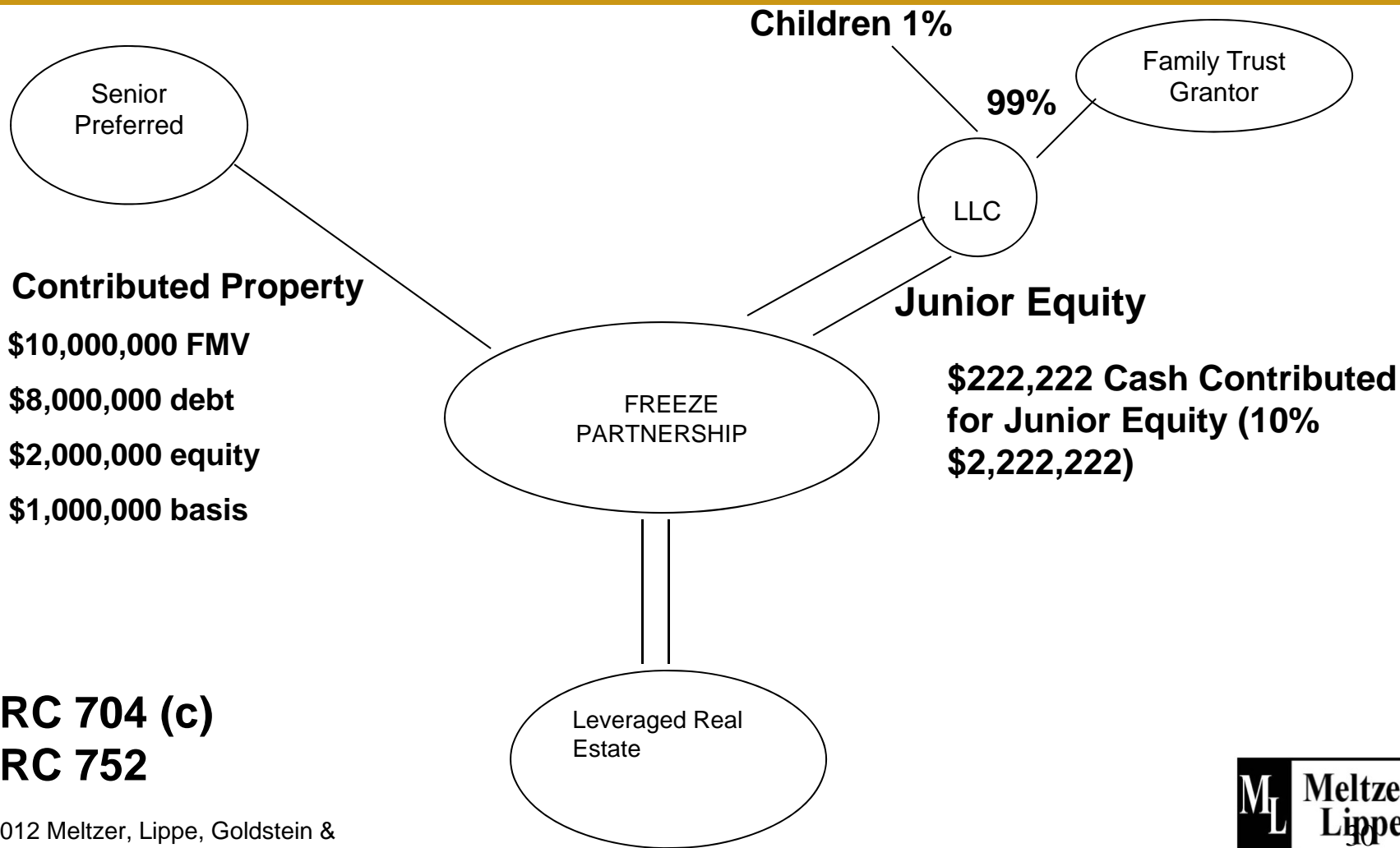
Carried Interest Legislation

- Profits interests could be treated as “investment services partnership interests” under proposed section 710
- Most recent proposal introduced by Congressman Levin on Feb. 14, 2012 - Proposed section 710 is not applicable unless more than 50 percent of the investment capital is provided by passive investors.
 - Does not seem to matter if capital is provided by family members
 - Either every partner should provide services or none.

Liabilities Must be Allocated to Preferred to Obtain Step Up on Negative Capital



Structure to keep Liabilities with Senior



IRC 704 (c)
IRC 752

Treatment of Liabilities

- The way liabilities are allocated determines partnership “outside” basis – and what gets stepped up upon death.
 - Section 752 (a) increase in a partners share of liabilities is considered to be a contribution of cash to the partnership
 - Section 752(b) decrease in a partners share of liabilities is considered to be a distribution of cash
 - If the shifting of liabilities causes a partner to be deemed to have received a distribution in excess of that partner’s basis in its partnership interest gain is recognized under section 731(c) of the Code.
 - **Inside basis is stepped up if there is a section 754 election.**

Allocation of Liabilities among Partners

- Section 752 governs allocations of liabilities among partners – who bears risk of loss?
- Treatment of Nonrecourse debt – three tiered approach
 - Tier 1 – Minimum gain
 - Tier 2 – Section 704 (c) minimum gain
 - Tier 3 – allocation based upon other significant partnership item with substantial economic effect

Forcing Debt Allocations by Agreement

- Wraparound Debt Structures on Contributed Property
- Indemnification Agreements



Leveraging the Partnership to Reduce Qualified Payments

Leveraging Up Example

- Real Estate contributed to Freeze LP
 - Asset (FMV) \$10,000,000.00
 - Adjusted Basis 1,000,000.00
 - Mortgage 8,000,000.00
- Net Equity \$ 2,000,000.00

Leveraging Up Example (continued)

- Balance Sheet

Asset (FMV)	\$10,000,000.
Mortgage	<u>- (8,000,000.)</u>
Equity	\$ 2,000,000.

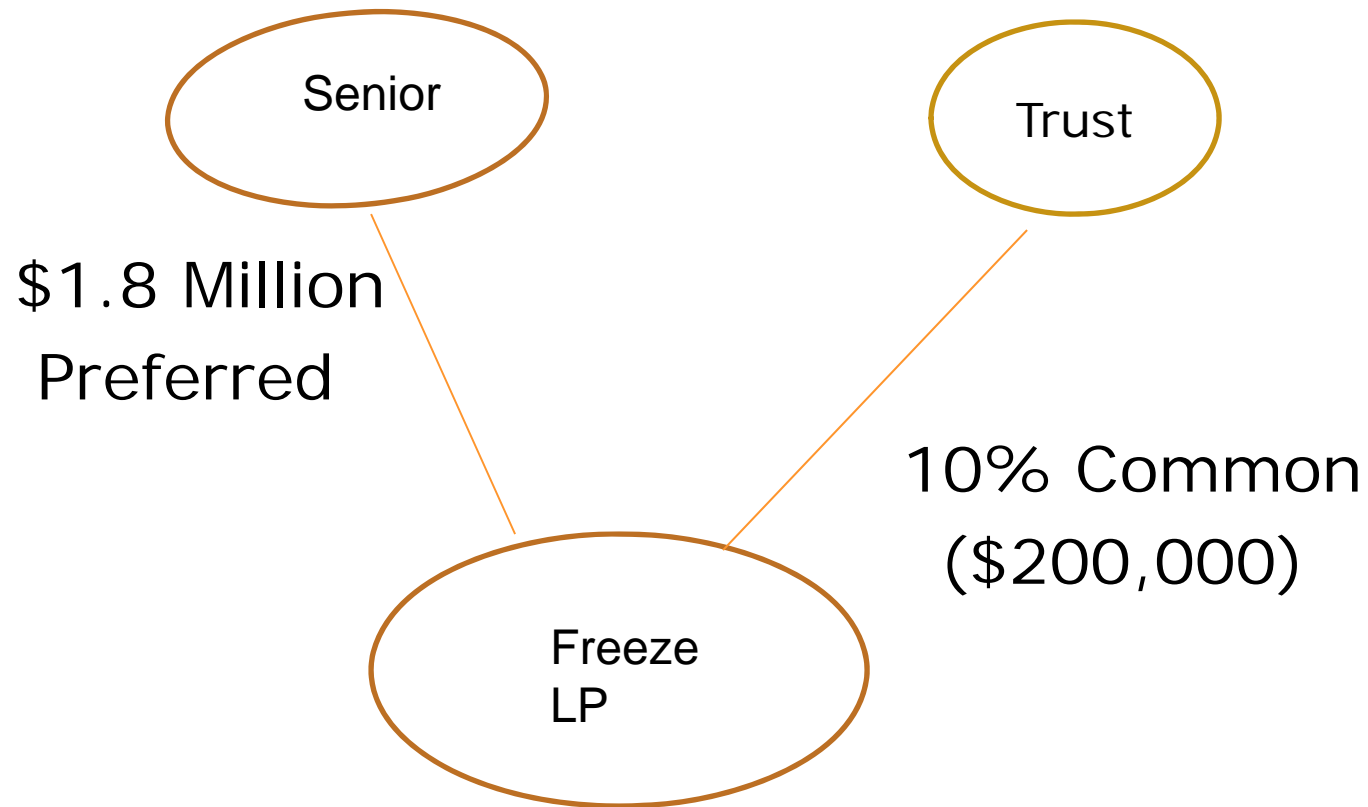
- Capital Accounts

Senior	\$ 1,800,000.
Junior	<u>+ 200,000.</u>
	\$ 2,000,000.

- Preferred return @ 8% = $1,800,000 \times .08 = \$144,000$

Leveraging Up Example

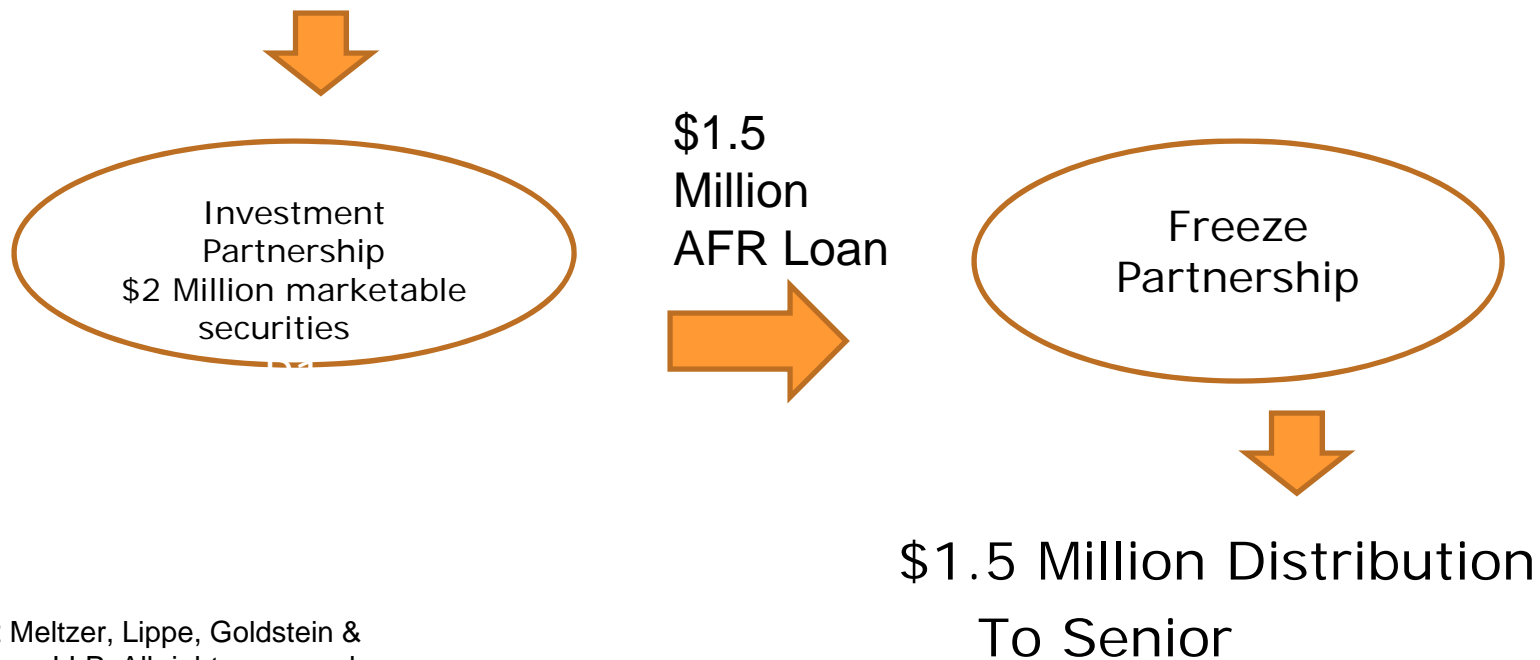
BEFORE



Leveraging Up Example (continued)

- Borrow against separate stock portfolio

\$1.5 Million Margin Loan



Leveraging Up Example AFTER

- New Balance Sheet

Asset (FMV)	\$10,000,000.
Liability (Mortgage)	\$ 8,000,000.
Liability (AFR Loan)	<u>\$ 1,500,000.</u>
Equity	\$ 500,000.

- Capital Accounts

Senior	\$ 300,000.
Junior	\$ 200,000.

Preferred return @ 9% = $\$300,000 \times .09 = \$27,000.$

Leveraging Up Example (continued)

Preferred Return	\$ 27,000
Interest on Mid Term AFR Loan (1.64%)	<u>\$ 24,600</u>
Total Leveraged Return to Senior	\$ 51,600
Compare Unleveraged Return	\$144,000
Compare Installment Sale	\$128,000



Debt Financed Debt Distributions

- Non Qualified Nonrecourse Liabilities
- Considered related to the transfer to the extent not allocated to the transferor under Section 752 like principles but without tier one or tier two. Thus, allocated in accordance with the manner in which a significant item is allocated under nonrecourse debt regulations under Section 752. Treas. Reg. 1.707-5(a)(2)(ii).

Contributions of Encumbered Property and Leveraged Distributions

Disguised Sale Rules of Section 707(a)(2)(B):

Under regulations prescribed by the Secretary --. . . . If (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property

Disguised Sale Rules

Under Treas. Reg. § 1.707-3(b)(1):

- Contribution and distribution will be treated as a sale if the facts and circumstances indicate that (1) the transfer of money would not have been made but for the transfer of the property, and (2) the distribution was not dependent on the "entrepreneurial risks" of the partnership's operations.
- Additionally, if within a two-year period there is a contribution by and distribution to a partner, the transfers are presumed to be a sale of the property to the partnership. This presumption is rebuttable only if "the facts and circumstances clearly establish that the transfers do not constitute a sale."

Will Pre or Post Contribution Borrowings Be Deemed Disguised Sales?

Categories of Borrowings:

- Recourse
- Nonrecourse
 - Qualified Nonrecourse
 - Non Qualified Nonrecourse

See Treas. Reg. Section 1.707-5(b)

Disguised Sale Rules (Cont.)

Recourse Debt

- Recourse debt is allocated to the partner who bears the risk of loss (e.g., the guarantor)
- See *Canal Corp. v. Comm'r* 135 T.C. 9 (2010) (guaranties must not be illusory)

Disguised Sale Rules (Cont.)

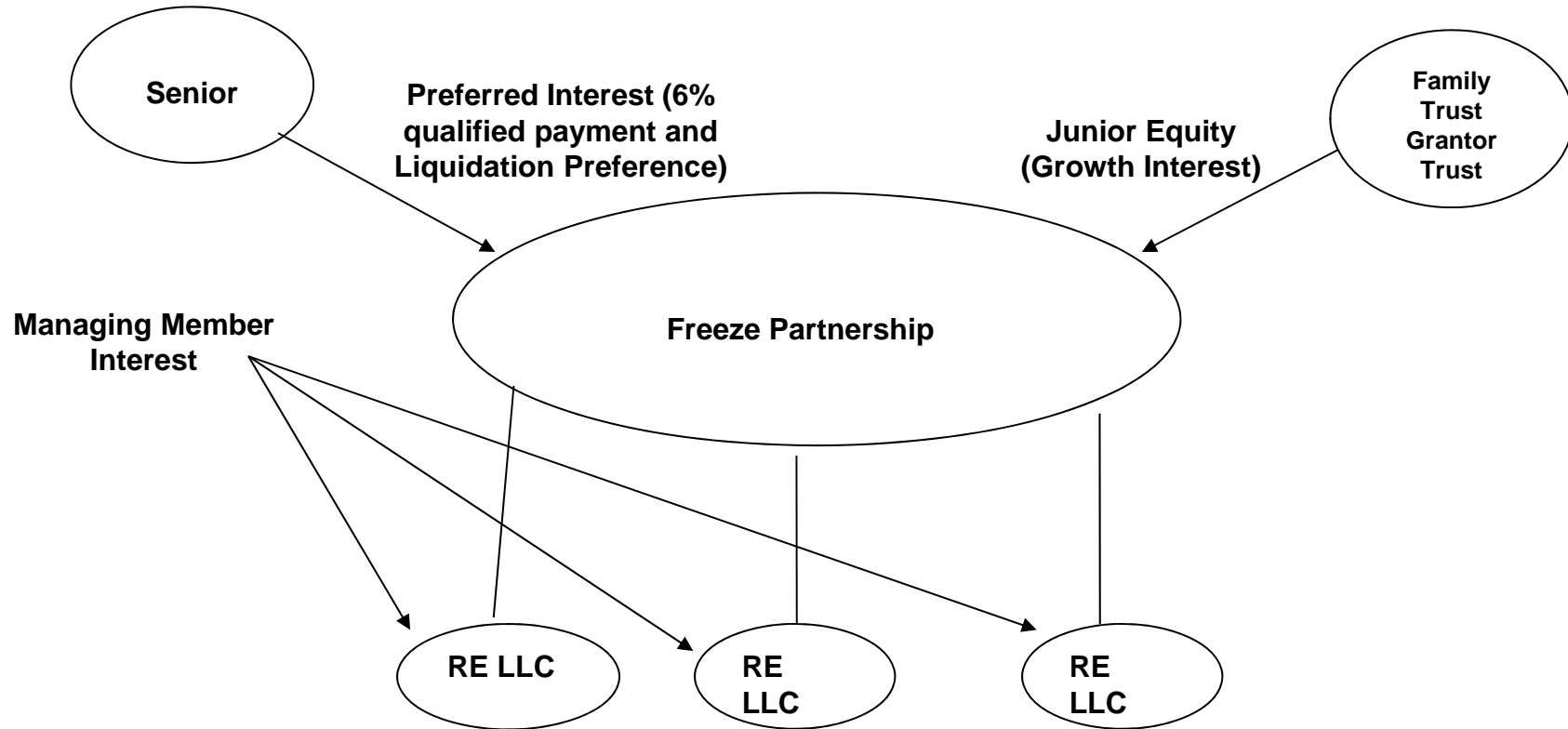
Non Recourse Debt

- Qualified Nonrecourse
- Non Qualified Nonrecourse

Debt Financed Debt Distributions

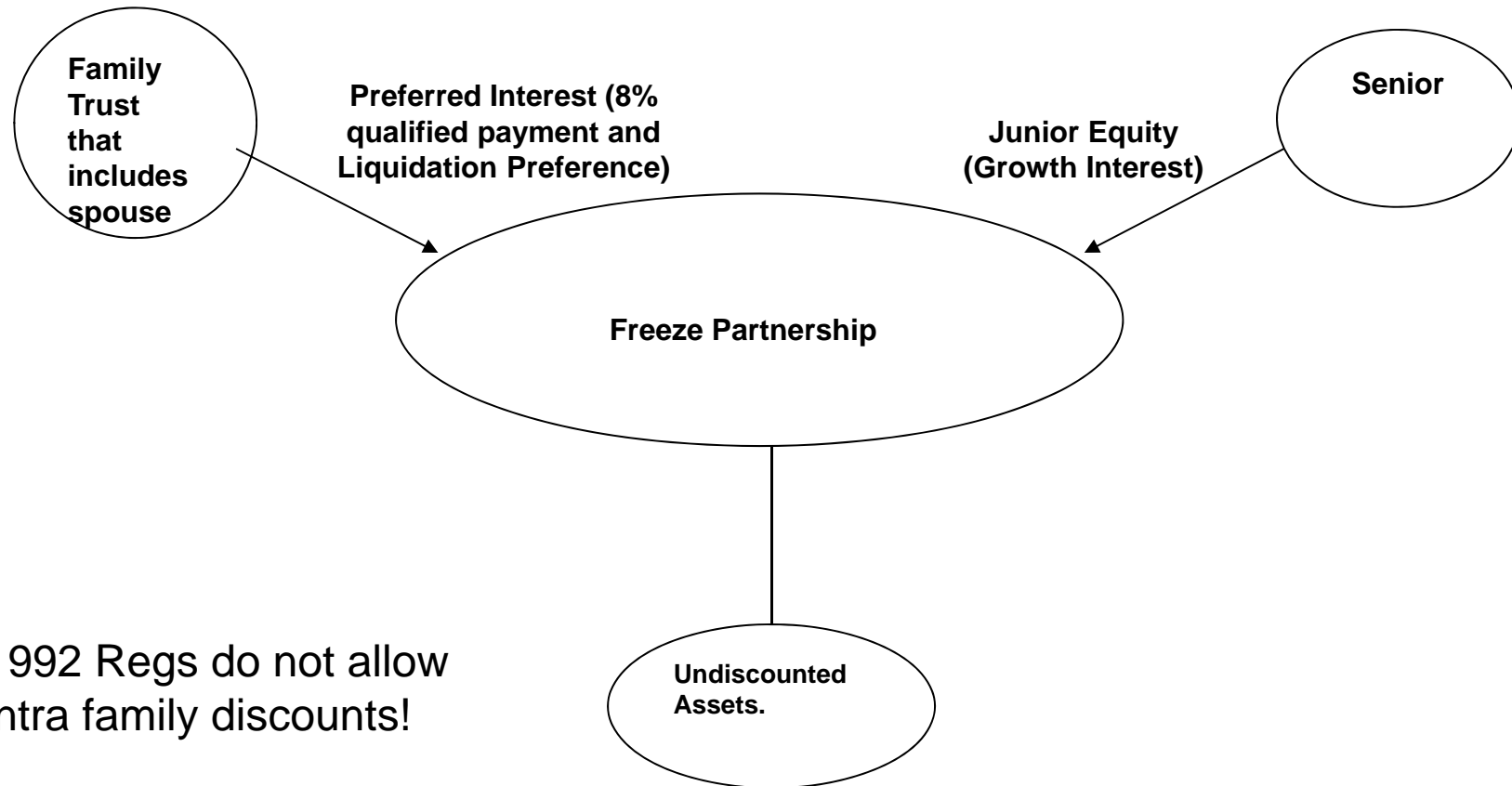
- Qualified Nonrecourse –
- Non incurred within 2 years of property contribution or if determined not incurred “in anticipation of the transfer” (Old and Cold). Rebuttable presumption that connected to the transfer if incurred within 2 years prior the transfer.
- Not old and cold (within past two years) but not in anticipation of the transfer.
- Liability allocated to capital expenditures to the contributed property.
- Liability incurred in the ordinary course of the trade or business.

Simple Real Estate Partnership Freeze



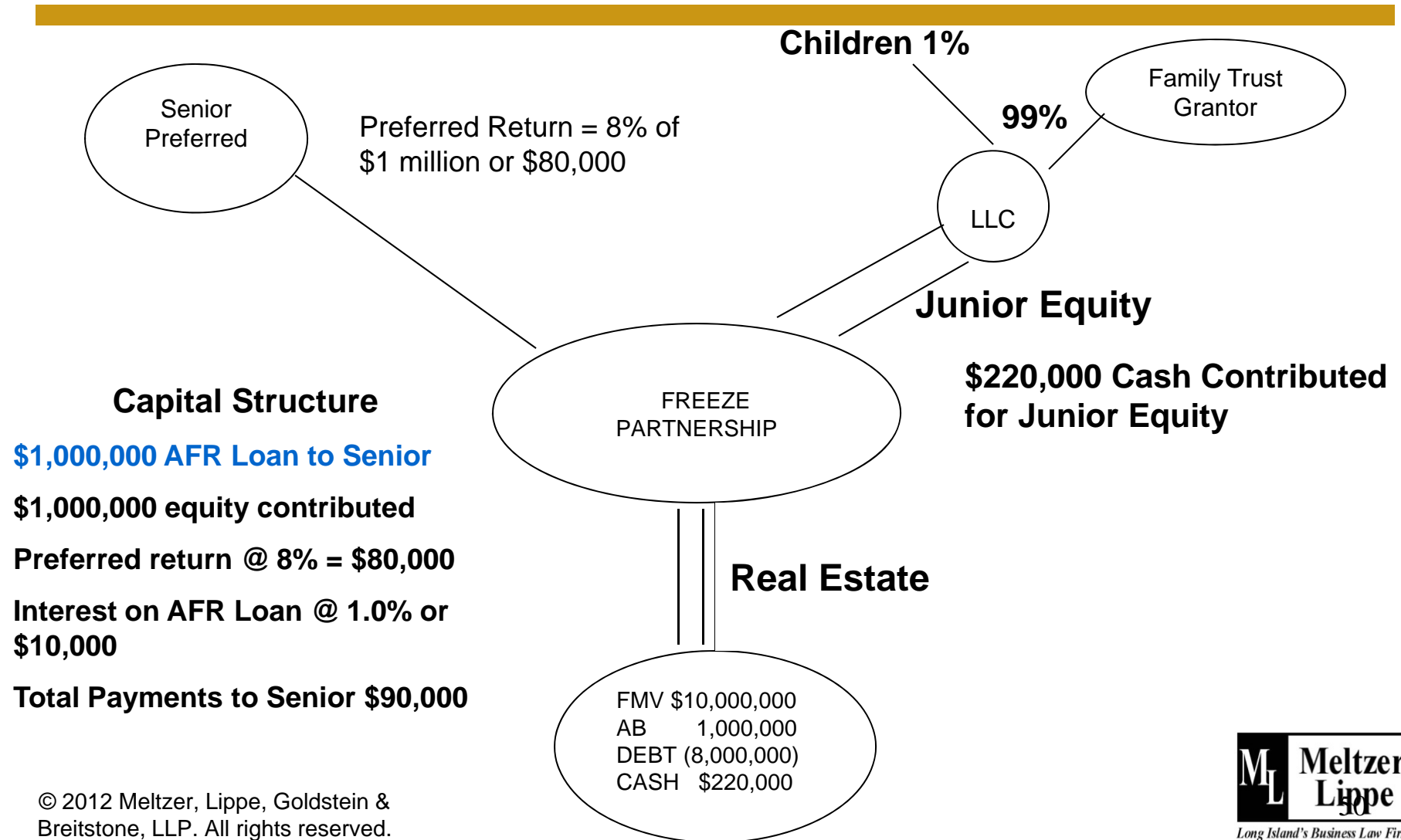
Rev. Rul. 93-12

Reverse Freeze – Remember when there was a return on investment?

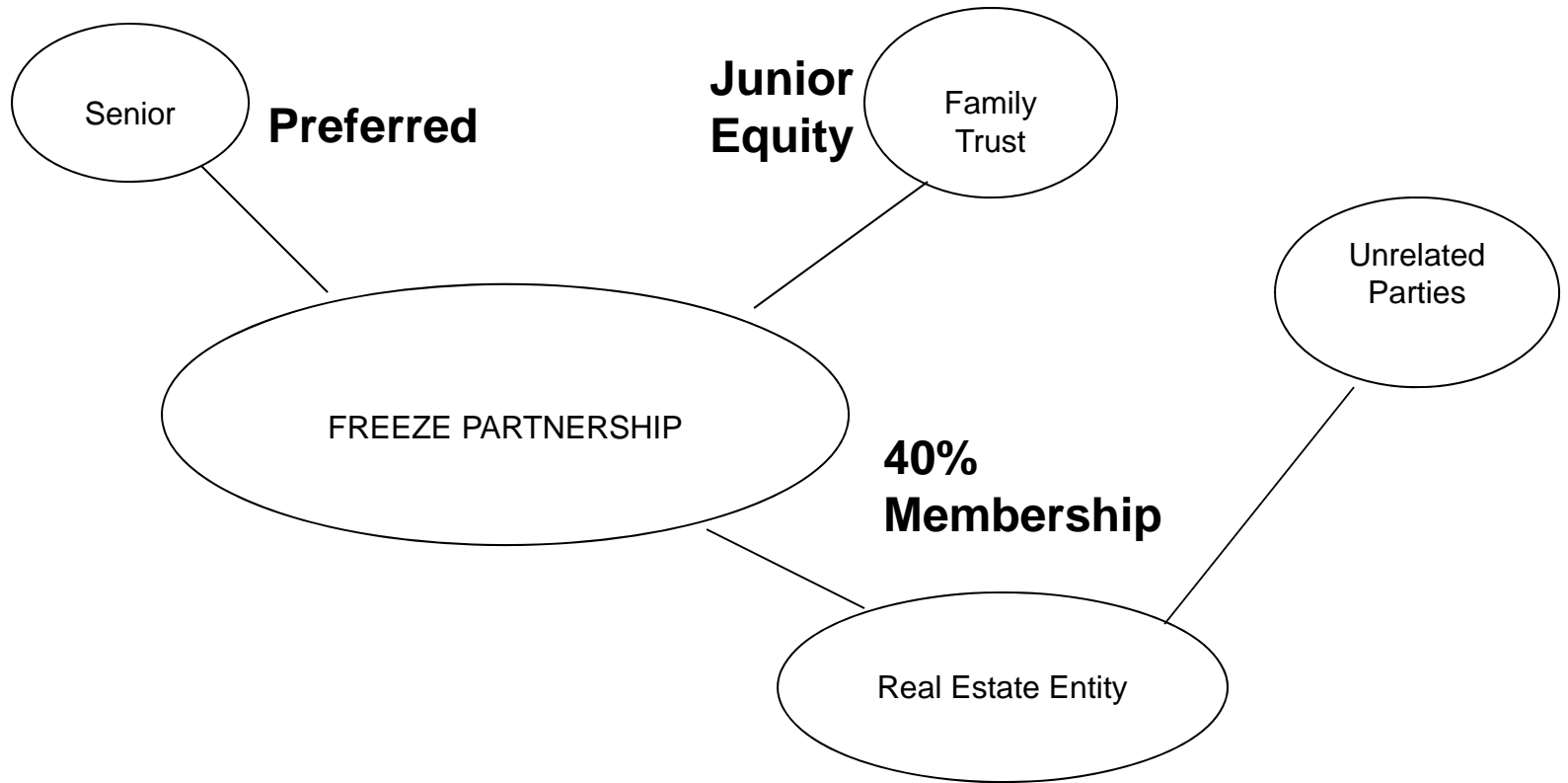


1992 Regs do not allow
intra family discounts!

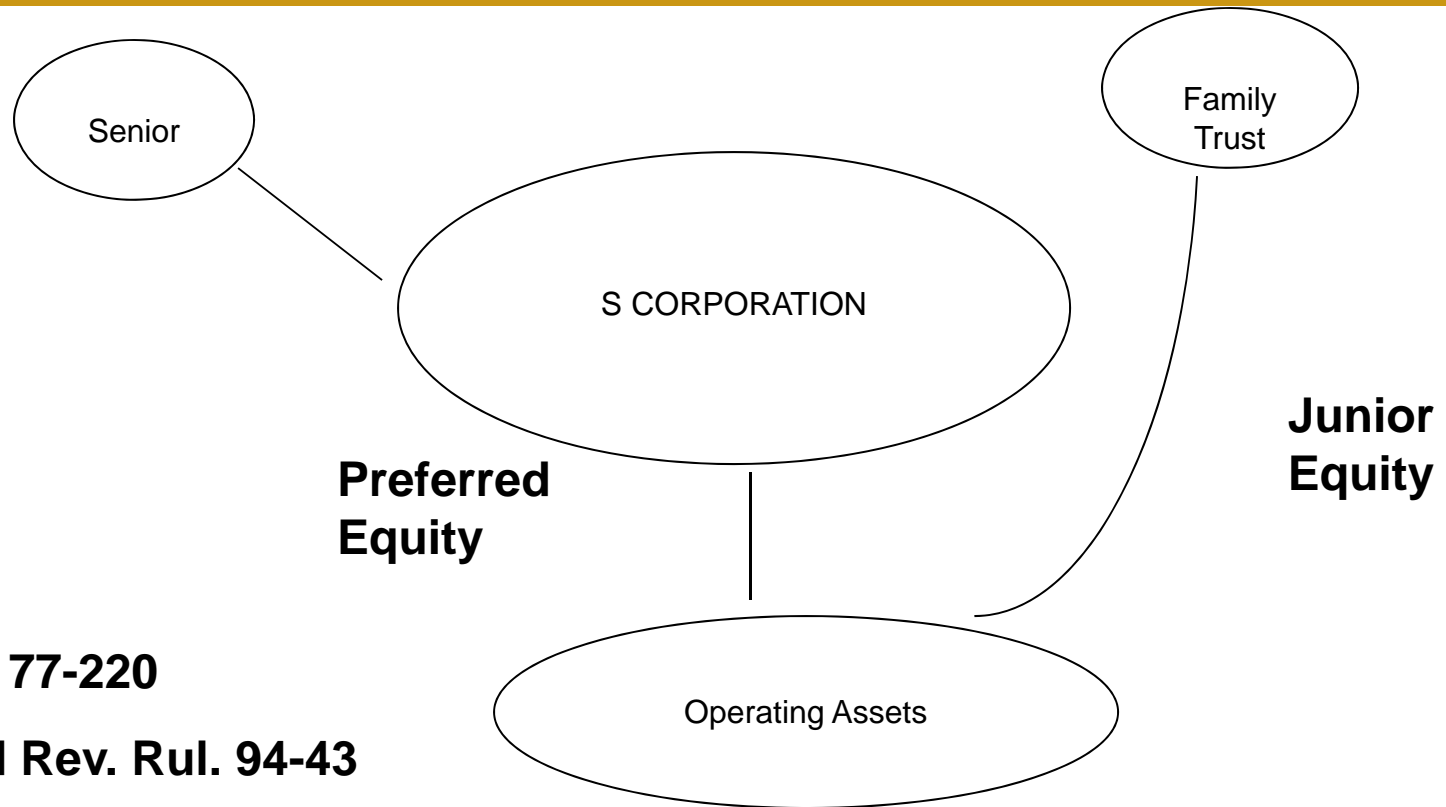
Leaky Freeze Solution



Best Discount Scenario (Contribution of Non-controlling Interest)



S CORPORATION FREEZE



- **Rev. Rul 77-220**
- **Revoked Rev. Rul. 94-43**
- **IRC Section 453(g) (related parties)**
- **Liquidation After Death IRC § 1239**

Estate Planning for Foreign Investment of U.S. Real Estate

- Structures for Foreign Investment of U.S. Real Estate include:
 - Direct Investment
 - U.S. Corporation
 - Foreign Corporation
 - Chain of Foreign and U.S. Corporations
 - Private REIT

Direct Investment

- Advantages:
 - Income taxed at top rate of 39.6% & 3.8% and capital gains taxed at top rate of 20% (or 25% if recapture).
 - Not subject to second-level tax on repatriation of net profits.
- Disadvantages:
 - Foreign owner must file U.S. tax return.
 - Dispositions of U.S. real estate subject to FIRPTA.
 - U.S. real estate subject to U.S. estate tax.

U.S. Corporation

- Advantages:
 - Shareholder not required to file U.S. tax return (but must disclose ownership on corporate return).
 - Liquidation can avoid second-level of U.S. tax.
- Disadvantages:
 - Corporate income subject to U.S. tax at 35%.
 - Dividends to Foreign Shareholder subject to 30% withholding tax.
 - Subject to U.S. estate tax.
 - Disposition of U.S. corporation subject to FIRPTA.

Foreign Corporation

- Advantages
 - Not subject to U.S. estate taxation.
- Disadvantages
 - Subject to FIRPTA.
 - Subject to U.S. tax at 35% rate.
 - Subject to “branch profits tax” of 30% on deemed dividend (subject to treaty benefits).

Chain of Foreign and U.S. Corporations

- In this structure, a foreign individual owns stock of a foreign corporation, which owns stock of a U.S. corporation. This is the most common structure.
- Corporate income is taxed at 35%.
- Dividends subject to 30% withholding, but may qualify for treaty benefits and reduced or zero withholding.
- No branch profits tax.
- No U.S. tax reporting by foreign individual.
- Possible to entirely avoid U.S. dividend withholding by liquidating U.S. corporation after disposition of U.S. real estate.