

Estate and Income Tax Planning for the Long Term Real Estate Investor

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Estate and Income Tax Planning for the Long Term Real Estate Investor¹

INTRODUCTION

Formulating an effective estate plan for the successful real estate investor can impact whether the investor's holdings, which may result from a lifetime of efforts, can continue for succeeding generations. Planning in this area is multidisciplinary. The tax and/or estate planning attorney plays a key role on the estate planning team. Where the family and business dynamics are complex (which is frequently the case), a team approach is required. The team may involve lawyers, accountants, financial advisors and human and business relationship experts. Since this paper is written for a tax institute, the emphasis will be on the role of the legal and tax advisors. However, the role of human and business relationship experts should not be overlooked.

For many real estate owners, one of their key advisors will be their transactional real estate attorney. The real estate attorney may have great knowledge and wisdom as to the client's circumstances, idiosyncrasies, and areas of vulnerability. However, they may not have sufficient expertise as an estate planner. Yet for the estate planner to be effective, it is necessary for that lawyer to gain an understanding of the individual client. Thus, a team approach can be most constructive assuming the professionals play well together.

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Sometimes the income tax aspects of estate planning for the real estate client are given short shrift. A trusts and estates lawyer may have an understanding of the transfer tax side but may lack familiarity with certain income tax aspects (such as partnership taxation) which can be a critical element. Planning for the real estate client frequently involves dealing with concepts such as “loss carryovers”, “phantom income” and “negative capital” – which are frequently present with the real estate client but are rarely found in other estate planning contexts. Application of mainstream estate planning techniques that may be appropriate for other business and investment interests to the real estate client may be perilous. As will be explained herein, mainstream techniques such as Grantor Retained Annuity Trusts (“GRATs”) and installment sales to intentionally defective grantor trusts (“IDGTs”) may fail to properly address the income tax considerations presented by the real estate client (whether the client knows it or not). These techniques may miss the opportunity to obtain a basis step up on phantom gain that results from liabilities in excess of basis. This arises where a property is depreciated over time and refinancings are used to cash out without current income taxation of the proceeds. Even worse, these techniques may, under some circumstances, inadvertently trigger phantom gain – which can be a significant problem especially since such gain should be able to escape taxation with proper planning. Moreover, such gain is “phantom” gain so there may not be liquidity to pay the income tax.

There are better techniques to deal with the unique income tax challenges frequently presented by the real estate client. One technique discussed herein is the freeze partnership – which is discussed in great detail herein - although this technique presents its own challenges.

THE NONTAX SIDE – BRIEFLY

One of the major challenges is to establish a plan for succession of management. Financing sources such as lenders and outside equity investors may insist that a plan for management succession will be in place. There is often a tension between the needs of the business to be managed effectively and the need to address the family concerns including perception of equity among successors and heirs. It is necessary to prepare appropriate documentation that provides rewards and incentives for management (whether or not family), to encourage appropriate expectations among family members and to maintain credibility with investors and business partners. Failure to provide for these concerns and others can undermine an otherwise viable business.

These agreements can also materially impact the ultimate income, estate, gift and generation skipping tax outcomes. For example, they can impact valuation subject to tax – but there are many other tax considerations that can impact the development of an appropriate estate plan for these types of assets.

FAMILY BUSINESS DYNAMICS

Many successful real estate businesses are also family businesses. Even where the founders are unrelated partners, there may be a strong temptation to bring family members into the business. If handled properly, this can help a business to flourish and continue into succeeding generations. However, if the right conditions do not exist, it can be a disaster. Many successful entrepreneurs are idealistic about their families – at least until reality sets in. Failure to provide for appropriate documentation of entity agreements can result in an unfortunate rude awakening.

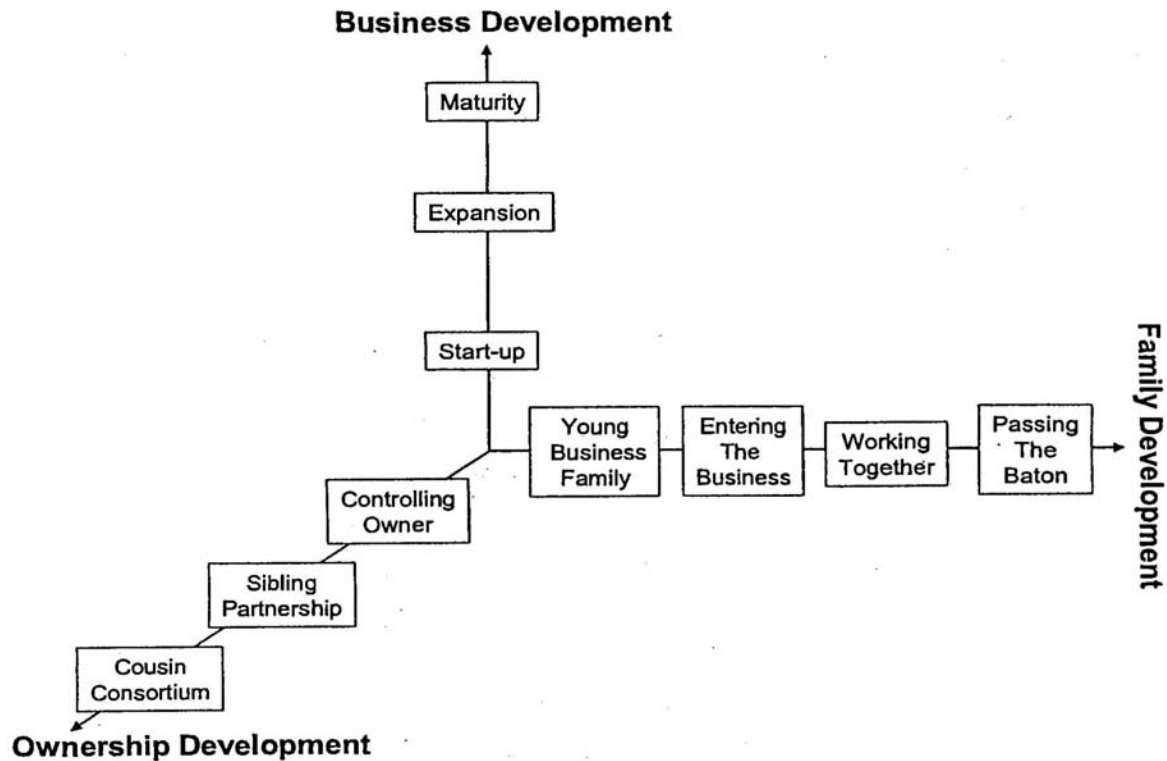
The personal attributes of the founder may not translate well into the next generation. The next generation may be faced with different challenges. For example, the

founder may be a true “developer” who creates opportunities and value. The second generation of owners may not have the same developer mindset and skills. However, the second generation may be more suited to maintain and grow the business. They may be more risk averse but more adept at building an organization. It is difficult to generalize.

Another challenge is the frequent need or desire to treat children equally. The following quote is instructive:

“It is not always feasible for all of the children to be involved in the management of the business. The fact that they are siblings does not automatically make them good future managers. Identify the children who will participate in the future business early, and ensure that they are properly trained and receive proper skills development.” *See Developmental Model (Gersick et al, 1999).*

As a business matures, the challenges that must be addressed in the entity agreements may likewise evolve and become more complex. The following diagram can be instructive of the conflicting considerations and dynamics that must be considered in drafting entity agreements:



See Rudolph B. van Buuren (Ph.D) *The Life and Times of a Family Business: A case study.*

As the foregoing diagram illustrates, the entity documents must be designed to allow for the development, growth and evolution of the family business dynamic. The needs of the business, and the tensions placed upon entity agreements, can significantly change as the business and the family dynamic evolves.

Drafting a set of entity agreements that can conform and adapt – or even drive – a particular succession plan can be a daunting task. However, it should be done at the earliest possible juncture. For example, if the plan is to gift or otherwise grant ownership interests to family members (as well as employees) the agreements, and the strictures and restrictions they entail, should be put into place before it becomes necessary to get disparate prospective owners to consent. Once they own their interests, they can present significant hurdles to implementing a

plan. The documents need to contain mechanisms to overcome the whims of the disparate family members.

POPULAR ESTATE PLANNING TECHNIQUES

Many of the mainstream estate planning techniques do not work well for the long term real estate holder. This is particularly true where the real estate is leveraged and has a low income tax adjusted tax basis. A brief discussion of the mainstream techniques, and the advantages and disadvantages for the long term real estate investor follows:

Grantor Retained Annuity Trusts (“GRATs”) – GRATs have historically been viewed as very low risk. This is because they are creature of statute. The rules governing GRATs are, in general, set forth in section 2702 of the Code and the regulations thereunder. A grantor retained annuity trust is a trust where the grantor transfers property and takes back an annuity. The annuity is determined on the basis of certain assumptions including a rate of return based upon the interest rate determined under section 7520 of the Code. Section 7520 generally provides a rate equal to 120 percent of the mid term applicable federal rate determined under section 1274 of the Code. This rate is artificially low as will be discussed below. A comprehensive discussion of GRATs is beyond the scope of this article.

A few points are important to be made. First, GRATs are not a construct of crafty tax advisors and are thus less likely to be subject to attack. The GRAT minimizes the valuation risk since in the event of a valuation challenge the annuity payments are self adjusting. In general, if the grantor does not outlive the term of the GRAT, most or all of the assets in the GRAT will be included in the grantor’s estate. GRATs do not work well for generation skipping tax planning since the generation skipping exemption cannot be allocated to the GRAT until the term of the GRAT expires – at which time the underling assets will likely have appreciated. This is not an efficient use of the generation skipping exemption.

When it comes to maximizing a basis step up under section 1014 of the Code, the GRAT, like other gift tax completed grantor trusts, will not allow a basis step up in the underlying assets of the trust. For depreciable real estate, especially low basis real estate with liabilities in excess of basis, this can be a major disadvantage of the technique. This aspect will be discussed in greater detail below.

Installment Sales to Intentionally Defective Grantor Trusts (“IDGT”) – Unlike the GRAT, the IDGT is not a creature of statute. Rather, it is a technique that has been gradually developed by estate planners. Thus, the outer bounds of propriety can be grey when designing a transaction using this technique. Like the GRAT the IDGT is a grantor trust. Thus, under well established law, a sale of assets by the grantor to the trust will generally not result in the recognition of gain for Federal and state income tax purposes. Note that for state and local transfer taxes this is not necessarily the case. However, the cessation of grantor trust could result in a taxable event – especially for liabilities in excess of basis.

A major disadvantage of the IDGT is the uncertainty of valuation. If there is a subsequent determination that the property transferred to the trust was undervalued, there could be an unintended taxable gift. This risk can be somewhat mitigated through the use of valuation clauses which are discussed in detail below. Similarly, if the property declines in value it could result in a loss of any gifting exemptions use to fund the trust initially.

A major advantage of the IDGT is that it can be generation skipping. Indeed, the allocation of exemption to the initial funding of the trust should allow significant leveraging of that exemption assuming the property appreciates.

Another major advantage of the IDGT is the low hurdle rate. Assuming the trust is adequately funded (so that the installment note taken by the seller is recognized as debt for tax

purposes), the debt should not need to accrue interest at greater than the applicable federal rate under section 1274 of the Code. A schedule of applicable federal rates is as follows:

REV. RUL. 2013 - 12 TABLE 1

• Applicable Federal Rates (AFR) for June 2012

Period for Compounding:	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.18%	.18%	.18%	.18%
Mid-term AFR	.95%	.95%	.95%	.95%
Long-term AFR	2.47%	2.45%	2.44%	2.44%

The Section 7520 rate is 3.2%

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Assuming a note of a term of 9 years is used, a mid term rate would be used. The mid term applicable federal rate was .95% for June 2013. Thus, assuming the underlying assets either appreciate or accrue income at least 1 percent the technique should result in the transfer of wealth on the excess to the grantor trust.

The major disadvantage of the IDGT, like that of the GRAT, is the inability to obtain a basis step up under section 1014 of the Code for the asset transferred to the trust. Where the property has a low basis and/or liabilities in excess of basis, this can be a major disadvantage and may result in the client paying more in taxes than if he had not done any planning.

Lastly, if the assets that constitute an active real estate business are transferred into a grantor trust in exchange for an installment note, it may be possible to cause the estate to be denied the very valuable ability to pay estate taxes over 15 years under section 6166 of the Code. This will be discussed in greater detail below.

The Freeze Partnership or LLC – The freeze partnership or LLC avoids the income tax pitfalls of the GRAT and the IDGT. With the freeze partnership or LLC, the person doing the planning (“Senior”) would transfer property into a partnership in exchange for a preferred or “frozen” interest. The junior equity would typically be transferred to a grantor trust. The junior equity would represent the growth potential in the underlying assets. The preferred or “frozen” interest would be retained in the estate of the grantor. Under income tax principals discussed in greater detail below, the liabilities in excess of basis and the capital value of the property contributed by the Senior, would be entitled to a basis step up under section 1014 upon the death of Senior. This is a distinct advantage of this technique over the GRAT and the IDGT. The disadvantage of this technique is that the hurdle rate is not the AFR or the 7520 rate. Rather it is a market return determined by appraisal. In structuring the plan, this higher hurdle rate can be a major disadvantage to this technique. Nevertheless, as discussed below, there may be ways of mitigating this disadvantage.

STRUCTURING THE ENTITY AGREEMENTS FROM A TAX PERSPECTIVE

FAMILY LIMITED PARTNERSHIPS AND FAMILY LLC: GENERALLY

“Family limited partnership” or “LLC”² are receiving scrutiny from the IRS as these entities are often perceived as artificially contrived to reduce valuation for individual

² Family LLCs are similar to FLPs in terms of the estate planning benefits that they offer, and are more commonly used. See Jim Schmidt, An Updated Look at Family Limited Partnerships, LLCs, (June, 2003), http://www.sw-cpa.com/bottomline/articles/2003-06/flp_update.htm. The differences between FLPs and Family LLCs are mainly legal differences, such as all members of an LLC having limited liability compared to only limited partners having

family members when the family at large enjoys the unrestricted benefits of the underlying assets. For example, as the IRS has successfully argued (at least in part) in some cases³ there may be little actual business purposes to the structure., such as, in *Holman v. Commissioner*,⁴ where the family partnership in question merely held a large block of stock in a single publicly held corporation. The tax court viewed the entity with some skepticism.

However, for an actively managed real estate portfolio, the existence of a well crafted partnership agreement or operating agreement that contains extensive restrictions on voting, participation in management of certain family members, and transferability, may be completely necessary for the ongoing viability of the business. A clear delineation of who is in control, the scope of their authority, and the rights and duties of each of the owners may be essential to keep in check the potential for infighting and tumult, which can be costly and disruptive. In these entities, the minority or noncontrolling owner does not have the unfettered control of the underlying assets whether or not there is family harmony at any given time. Ultimately, the interests held by these noncontrolling owners should have values no greater than those of other noncontrolling owners in a business or investment entity. The IRS is unlikely to presume that these entity agreements are merely window dressing to create the maximum disappearing estate and gift tax value through discounting and other valuation techniques.

The body of case law has provided significant guidance as to the valuation of interests in family controlled real estate business through a limited partnership or limited liability company. Recent cases involving the valuation of interests in closely held entities for estate and gift tax purposes allowed the following discounts:

limited liability in FLPs. See Family Limited Partnerships (“FLPs”) and Limited Liability Companies (“LLCs”), (2002), http://www.estate-plan.com/pdf/Art_FLPLLC.pdf.

³ See, e.g., See Holman v. Comm’r, 601 F.3d 763, 772 (8th Cir. 2010)(referring to the family partnership as a “wrapper”).

⁴ Holman v. Comm’r, 601 F.3d 763 (8th Cir. 2010).

<u>Case</u>	<u>Year</u>	<u>Interest Transferred</u>	<u>Underlying Property</u>	<u>Lack of Control Discount</u>	<u>Lack of Marketability Discount</u>
<u>Estate of Gallagher v. Comm’r, T.C. Memo 2011-148</u>	2011	15% LLC interest	Newspaper and media company	23%	31%
<u>Holman v. Comm’r, 601 F.3d 763 (8th Cir. 2010)</u>	2010	1999- 14.265% LLP interest 1999- 70.054% LLP interest 2000- 3.285% LLP interest 2001- 5.431% LLP interest	Marketable securities	1999- 11.32% 1999- 11.32% 2000- 14.34% 2001- 4.63%	12.5%
<u>Pierre v. Commissioner, T.C. Memo 2010-106</u>	2010	50% LLC interest	Cash and marketable securities	8%	30%
<u>Estate of Litchfield, T.C. Memo. 2009-21</u>	2009	43.1% shares of an S corporation	Farmland, marketable securities, and a subsidiary corporation that owned and operated a public grain elevator and sold crop insurance and certain services	14.8%	25%
<u>Litchfield</u>	2009	22.96% shares of an S corporation	Farmland, marketable securities, and a subsidiary corporation that owned and operated a public grain elevator and sold crop insurance and certain services	11.9%	20%
<u>Gross v. Commissioner, T.C. Memo. 2008-221</u>	2008	22.25% limited partnership interest	Marketable securities	35% combined	
<u>Astleford v. Commissioner, T.C. Memo. 2008-128</u>	2008	50% general partnership interest	Real estate	30% combined	
<u>Astleford</u>	2008	30% limited partnership interest	Real estate	17.47%	22%

Nevertheless, the IRS has launched some successful attacks on family controlled partnerships and limited liability companies which, attacks have either greatly limited discounting or brought the assets back into the estate under IRC section 2036. A discussion of these authorities follows.

SECTION 2036: IRS ATTACKS OF FLP'S AND FAMILY LLC'S

The IRS has success in challenging some FLPs and Family LLC's where the fact patterns have provided a basis for including the assets of the entity in the estate of its founder under section 2036 of the Code. The success of the IRS in these cases represents not an indictment of this type planning – but rather a reflection of the fact that some taxpayers have done a really bad job of respecting and implementing their structures. The applicable maxim is that “bad facts make bad law”.

Section 2036 requires that transfers with a donor retained life estate are included in the donor's gross estate, unless they are a bona fide sale for adequate and full consideration. Section 2036 provides that a donor has a retained life estate if that the donor retains (1) “the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income there from.”⁵

Various court challenges against family partnerships were brought by the IRS prior to the late 1990s and early 2000s. However, these challenges had little success – at least not until the IRS began to assert that section 2036 applies to bring assets transferred into an FLP back into the donor's gross estate.⁶ However, beginning in 1997⁷ the Courts began to uphold the

⁵ I.R.C. § 2036(a). See generally Stefan F. Tucker & Mary A. Mancini, 14th PLI Annual Real Estate Tax Forum 53 (2d Vol. 2011).

⁶ See e.g., Hackl 118 T.C. 279 (2002); Shelly D. Merritt, Family Limited Partnerships After Hackl and Strangi: Still a Viable Planning Technique?, (November 12, 2003)., <http://www.cobar.org/index.cfm/ID/20720/subID/4007/TAX/Family-Limited-Partnerships-After-Strangi-And-Hackl:-Still-a-Viable-Planning-Technique?/>.

IRS's challenges that Section 2036 should be used to bring assets transferred into an FLP back into the donor's gross estate⁸ based on the theories of an express or implied understanding that the assets would be available to the donor (Section 2036(a)(1)) and actual beneficial enjoyment by the donor (Section 2036(a)(2)).⁹

The theory of the existence of an express or implied understanding that the assets are available to the donor has been successfully argued by the IRS when some or all of the following facts are present: the donor made a death bed transfer of assets into an FLP¹⁰; the donor transferred the majority of his/her assets to an FLP without retaining a sufficient amount for his/her support¹¹; the donor occupied the transferred residence without paying rent¹², the donor commingled personal and partnership assets¹³; the donor used partnership assets for personal use¹⁴; and the donor received disproportionate distributions from the partnership.¹⁵ For example, in Strangi¹⁶, the Court held that since the donor transferred most of his assets to the FLP there was an implied understanding that the FLP would support him and since the donor

⁷ See Estate of Schauerhamer v. Comm'r, 73 T.C.M. 2855 (1997) (holding that since the partner retained a right to the income of the contributed property the asset should therefore be included in the partner's estate),

⁸ See e.g., Strangi v. Comm'r, 85 T.C.M. 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005); Kimbell v. U.S., 244 F.Supp.2d 700 (N.D. Tex. 2003), vacated and remanded, 371 F.3d 257 (5th Cir. 2004); Estate of Thompson v. Comm'r, 84 T.C.M. 374 (2002); Harper v. Comm'r, 83 T.C.M. 1641 (2002); Estate of Turner v. Comm'r, 102 T.C.M. (CCH) 214 (T.C. 2011) supplemented sub nom. Turner v. Comm'r, 18911-08, 2012 WL 1058162 (T.C. Mar. 29, 2012).

⁹ See Tucker, supra note 8.

¹⁰ See Harper, 83 T.C.M. 1641 at 1 (holding that the property was brought back into the decedent's estate where the FLP was formed when the taxpayer was 86 and was suffering from cancer).

¹¹ See, e.g., Thompson, 84 T.C.M. 374 at 16 (holding that the property was brought back into the decedent's estate where the decedent transferred the majority of his assets to the FLP and therefore there was an "implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived"); See also Strangi, 85 T.C.M. 1331 (2003) Strangi (holding that since the donor gave 98% of his assets there was an implied understanding that his children and the partnership would be his primary source of support).

¹² See, e.g., Strangi, 85 T.C.M. 1331 (2003) (holding that there was an implied understanding because the donor occupied the transferred residence without paying rent for two years).

¹³ See, e.g., Turner, 102 T.C.M. (CCH) 214 (T.C. 2011).

¹⁴ See id.

¹⁵ See id.

¹⁶ See e.g., Strangi v. Comm'r, 85 T.C.M. 1331 (2003), aff'd, 417 F.3d 468 (5th Cir. 2005).

continued to reside in his transferred residence without paying rent, the property was included in the donor's gross estate.¹⁷

Prior to Strangi, the IRS had limited success in using the theory that retained control constituted beneficial enjoyment which could support bringing transferred property back into the donor's estate. For example, in U.S. v. Byrum, 408 U.S. 125 (1972), the Supreme Court held that the donor did not retain the right to control the beneficial enjoyment of the property transferred to a trust where he was a majority shareholder and had the right to elect directors, because he had a fiduciary duty "not to misuse his power by promoting his personal interests at the expense of the corporate interests."¹⁸

Strangi is perhaps the seminal case for the IRS successfully asserting that property transferred into an FLP should be included in the donor's gross estate if the donor retains control over the beneficial enjoyment of the property. In Strangi, the Tax Court held that the property was included in the donor's estate because (1) the donor "retained the right *acting in conjunction with other Stranco shareholders*, to the property because he could designate who can enjoy benefit from the property by acting together with other Stranco shareholders to revoke the partnership"¹⁹ and (2) the donor placed his attorney in fact in a position to make distribution decisions".²⁰ The Tax Court distinguished this case from Byrum because in Byrum the donor had fiduciary duties to unrelated parties, there was an independent trustee, and the trust held an operating business and not only investment assets.²¹

¹⁷ See also Thompson, 84 T.C.M. 374 at 16 (holding that the property was brought back into the decedent's estate where the decedent transferred the majority of his assets to the FLP and therefore there was an "implied understanding that his children would agree to his requests for money from the assets he contributed to the partnerships, and that they would do so for as long as he lived")

¹⁸ See U.S. v. Byrum, 408 U.S. 125 (1972).Merritt, supra note 9.

¹⁹ See Strangi, 85 T.C.M. at 13.

²⁰ See id. at 15.

²¹ See generally Strangi 85 T.C.M. 374.

However, the Service was not so successful in Mirkowski v. Comm’r, 95 T.C.M. 1277 (2008), where the Tax Court held that property is not brought back into the donor’s estate under Section 2036(a)(2) where the donor was precluded from participating in all three of the following: determining income allocation, determining the amount of cash to distribute, and amending the agreement.²²

As stated above, Section 2036 does not apply and the transferred property is not brought back into the donor’s gross estate when there is a bona fide sale for adequate and full consideration.²³ This issue was addressed in Kimbell v. Commissioner²⁴, where the Fifth Circuit Court of Appeals held that there is a three part test to determine whether there is full and adequate consideration when assets are transferred to a partnership in exchange for a partnership interest; (1) if the interests given to the partners are proportionate to the fair market value of the assets they contributed to the partnership, (2) if the capital accounts are properly maintained to reflect these contributions, and (3) if the distributions in liquidation of the partnership or of the partners’ interests in the partnership are determined on the basis of their respective capital balances.²⁵

As stated in Kimbell, even if the full and adequate consideration test is met, a separate bona fide test must then be passed. The following factors are used to determine when the bona fide test is met: if the donor retains sufficient assets outside the Partnership for his/her own support and there is no commingling of Partnership and personal assets²⁶; if the Partnership formalities are satisfied and the assets contributed to the Partnership are actually assigned to the

²² See generally Mirkowski v. Comm’r, 95 T.C.M. 1277 (2008). Edward J. Giardina, Just When You Thought Securities FLPs Were Dead: Mirkowski Beats Section 2036(a)(2), (April, 2010).

²³ See I.R.C. § 2036(a).

²⁴ Kimbell v. United States, 371 F.3d 257, 266 (5th Cir. 2004).

²⁵ Id.

²⁶ See id. at 267.

Partnership²⁷; if the assets contributed to the Partnership include interests that require active management²⁸; and if there are several credible non-tax business reasons for the formation of the Partnership,²⁹ “such as asset protection, reduction of transaction and transfer costs, preservation of the assets within the family, and mediation of disputes by arbitration”.³⁰

However the bona fide test is not met when the following factors are present: if the donor stands on both sides of the transaction; if the Partnership was established without the other family members; if there is co-mingling of personal and partnership funds and paying estate planning fees from the partnership; and if assets were not transferred to the partnership until months after its formation.³¹

Based on the opinions in the seminal cases of Strangi, Thompson, and Kimbell, there is a significant risk that Section 2036 can be used to bring assets transferred to an FLP or Family LLC back into the donor’s estate if he retains the possession or enjoyment of, or the right to the income from, the property, or the right to designate the persons who shall possess or enjoy the property or the income. However, even if such interests are retained the property will not be brought back in the donor’s gross estate if there was a bona fide sale for an adequate and full consideration.

PROPER VALUATION TECHNIQUE FOR FLP/FLLC: INCOME VS. NAV APPROACH

Many estate plans involve the formation and transfer of family owned limited partnerships (“FLP”) or LLCs (“FLLC”). As discussed above, FLPs and FLLCs have the ability to generate significant advantages to the client. The client can transfer assets to the FLP/FLLC and maintain control over the assets through the General Partner or Manager position. The client

²⁷ See id.

²⁸ See id.

²⁹ See id.

³⁰ See HAROLD WEINSTOCK & MARTIN NEUMANN, PLANNING AN ESTATE 427 (Thomson Reuters/West, 2010).

³¹ See Turner, 18911-08, 2012 WL 1058162 at 17.

than transfers the non-controlling interests, which represent the bulk of the value of the FLP/FLLC, out of his or her estate at significant a discount. Needless to say, the valuations of these FLLCs/FLPs have been extensively challenged by the IRS during audits and have resulted in numerous cases.

One issue of contention is the proper method of valuation to use in appraising interests in a FLLC/FLP. There are two primary methods of evaluation that appraisers use: The first is called the net asset value approach, or NAV approach. This approach, in simple terms, takes the fair market value of the underlying entities held by the FLLC/FLP, primarily calculated based on comparable assets that have been sold recently, sums them up, and then applies discounts to arrive at the valuation. The second approach is the Income approach. The income approach uses a different analysis; it takes the cash flow that the partnership generates and calculates the value based on that.

These two approaches, while both trying to determine the price that a willing buyer and seller would agree upon in an arm's length, market transaction, more often than not end up with different significant values. The IRS and taxpayers often argue about how much weight should be given to each valuation approach. Typically both approaches are done and then in many cases a controversy erupts between the IRS and the tax payer as to how much weigh to give to each of these approaches in averaging out a final valuation.

The courts have given fairly clear guidance as to when each approach is appropriate and how much to weigh each of approaches. The courts consider the net asset value approach more appropriate to a liquidation value. In other words, if someone were to buy the FLLC/FLP; with plans to liquidate the partnership and sell out the underlying assets, then the NAV approach would be the analysis used to determine what the FLLC/FLP is worth to the purchaser. On the other hand, the income approach is more suitable to someone valuing the

FLLC/FLP in terms of a continuing enterprise and a going concern. Such a potential buyer would care more about the cash flow and rate of return. Therefore, the Courts have been clear that to the extent the FLP/ FLLC/FLP was operated and structured as an ongoing business that is how much weight should be given to the Income approach. To the extent the FLLC/FLP was operated as a passive investment company that is how much weight should be given to the NAV approach. Public Letter Ruling 59-60, the seminal guidance from the IRS on valuations of entities, also makes the same point. In Section 5, it states that when valuing operating companies, the appraiser shall “accord primary consideration to earnings,” and when valuing passive investment/holding companies the appraiser may weigh more heavily the underlying values of the company’s assets. The following cases are illustrative:

Weinberg³² dealt with a dispute as to the valuation of an interest in a Family Limited Partnership that owned an apartment complex. The taxpayer in this case argued that both the Income approach and the NAV approach were appropriate while the IRS argued that only the income approach was appropriate. The IRS supported its argument as the taxpayer did not have a controlling interest in the FLP and therefore the NAV approach “is inappropriate for valuing the subject interest ... because the partnership’s underlying asset was income-producing real estate. Respondent argues that the net asset value is irrelevant because a hypothetical buyer could not control the sale of the underlying property or the liquidation of the partnership.”

The Court held that both the Income and NAV approach should be used, with a weighting of 75/25 for the Income and NAV. This weighting was proper as it “adequately reflected the attributes of this partnership.” In supporting the 25% NAV weighting the Court says: “The net asset value should still be considered because the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a

³² TCM 2000-51 (2000)

stream of rental income.” However, the income approach was more appropriate as the FLP was operated as an ongoing concern and as such the cash flow analysis is more important than the liquidation value.

Andrews³³ was a dispute over the valuation of stock in several closely held corporations that were involved primarily in the ownership, operation, and management of commercial real estate properties. Among the contested issues was to what extent each of the NAV and income approaches should be used.

The Court identified that the corporations had characteristics as both passive investment companies and therefore NAV is appropriate and also as active operating companies and therefore income approach is appropriate. NAV is appropriate as “the value of the underlying real estate will retain most of its inherent value even if the corporation is not efficient in securing a stream of rental income. Income approach is appropriate because “The corporations are businesses, engaged in the maintenance and management of these real estate properties. Thus, some of the value attached to the corporations must be based upon the operating nature of the businesses, with attention paid to their earnings and dividend history, management, and prospects for growth.”

Dunn³⁴ was a dispute as to the valuation of shares in a private company that rented out heavy equipment. The Tax Court had used both NAV and income approach, weighted 65/35. The Court of Appeals questioned if the NAV approach was appropriate at all as the company was clearly a going concern and ruled that a 85, income/15, NAV split was appropriate.

The company was and had always been “a viable operating company” which “earned a significant part of its revenues from selling services as well as renting equipment” and

³³ 79 TC 938 (1982)

³⁴ 301 F.3d 339 (2002)

that there were “significant active operational aspects to the company as of the valuation date.” The Court found little likelihood that the company would be liquidated and therefore the NAV approach was not appropriate; “Liquidation would be expensive and time-consuming.” The Court mocked the IRS’s insistence on exclusively using a NAV approach: “Consequently, the Commissioner’s insistence at trial that the value of the subject stock in Dunn Equipment be determined exclusively on the basis of the market value of its assets, undiminished by their inherent tax liability-coupled with his failure to adduce affirmative testimony of a valuation expert-was so incongruous as to call his motivation into question. It can only be seen as one aimed at achieving maximum revenue at any cost, here seeking to gain leverage against the taxpayer in the hope of garnering a split-the-difference settlement-or, failing that, then a compromise judgment-somewhere between the value returned by the taxpayer (which, by virtue of the Commissioner’s eleventh-hour deficiency notice, could not effectively be revised downward) and the unsupportedly excessive value eventually proposed by the Commissioner.” “The Commissioner’s legally and factually absurd contention at trial that no weight should be given to the Corporation’s earnings-based value and that its value should be based entirely in an asset-based approach.”

The Court ruled that there should be no adjustment for the “likelihood of liquidation” as that likelihood is built-in to both the income approach (that the assets will definitely be retained) and the NAV approach (that the assets will definitely be sold). The Court determined the weight to be given to each approach by calculating “the likelihood of liquidation vis-à-vis the likelihood of indefinitely retaining and using the assets”

In Knott³⁵ the Court, in valuing a partnership that owned a rental apartment project held that the NAV approach is not appropriate as: “[the partnership] was an ongoing business. There is no indication that the partners intended to liquidate ... as of the date of the trial, they had not done so. Thus, liquidation value is not an appropriate measure of value in this case.” Also in Deputy³⁶, the Court held that the income approach was correct as “the income approach is the best approach for valuing [the LP], a long-established, financially successful, closely held operating company that has shown consistent profit and growth.” “Generally, we agree...that an asset value approach is inappropriate in valuing a long-established, financially successful operating company.” Finally, in Giustina³⁷, in valuing an interest in a FLP that held timberlands, the Court held “the percentage weight to be accorded the cash flow method should be equal to the probability that the partnership would continue to be operated as a [operating] company.”

PARAMETERS OF ENTITY AGREEMENTS

In 1990, Congress enacted Sections 2703 and 2704 to curtail certain types of tax avoidance. These strategies used restrictions in entity agreements to discount values of assets with no true loss in value or control to the owners. This allowed for the transfer of property to family members at a discounted value, and therefore lowering transfer taxes.³⁸

In general, Section 2704(b) has not been a very effective tool for the IRS to combat valuation discounts. Taxpayers have figured out ways to structuring around this

³⁵ TCM 1988-120

³⁶ TCM 2003-176

³⁷ TCM 2011-141

³⁸ Section 2703 was enacted because of the concern that taxpayers were using restrictions in entity agreements to lower taxes by artificially discounting values of the assets with no true loss in value or control to the owners. Section 2704 was enacted to prevent taxpayers from transferring property to family members at a discounted value, and therefore lowering transfer taxes, when there is no permanent restriction. See Rick J. Taylor, Discount Partnership Arrangements Still Can be Used to Reduce Transfer Taxes, vLex (June 1992) <http://law-journals-books.vlex.com/vid/discount-arrangements-reduce-transfer-53337565>. Rick J. Taylor, Discount Partnership Arrangements Still Can be Used to Reduce Transfer Taxes, vLex (June 1992) <http://law-journals-books.vlex.com/vid/discount-arrangements-reduce-transfer-53337565>.

provision. The IRS has had greater success basing its attacks on Section 2703 to stop taxpayer use of discounted values for the assets without a real business purpose and without loss of actual value or control by the owners. Thus, the IRS has had limited success in applying section 2703 to limit valuation discounts where there was clearly no business purpose for the FLP, such as when the only asset in the FLP was stock of a publicly traded company. These authorities are discussed in greater detail below.

1. **IRS's Lack of Success Using 2704(b) to Disregard Restrictions in Determining Valuation**

The IRS has not had success in using Section 2704(b) to challenge valuation discounts for transferred FLP interests. Section 2704(b) provides that when valuing a transfer of interest in a controlled³⁹ partnership or corporation (“entity”)⁴⁰ to or for the benefit of a family member⁴¹, applicable restrictions on the ability to liquidate the entity are disregarded.⁴² The Treasury Regulations provide that “a restriction is an applicable restriction only to the extent that either the restriction [on an entity’s ability to liquidate] by its terms will lapse at any time after the transfer, or the transferor (or the transferor’s estate) and any members of the transferor’s family can remove the restriction immediately after the transfer”,⁴³ and the restrictions are more limiting than state law.⁴⁴ The following **however** are not considered applicable restrictions: any liquidation restriction that is less restrictive than state law,⁴⁵ even a restriction listing a term of

³⁹ Control means at least 50% of the stock of a corporation, at least 50% of the capital or profits interests in a partnership, or in the case of a limited partnership the holding of any interest as a general partner. I.R.C. §2701(b)(2).

⁴⁰ “An individual shall be treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust, or other entity. If any individual is treated as holding any interest by reason of the preceding sentence, any transfer which results in such interest being treated as no longer held by such individual shall be treated as a transfer of such interest”. §2701(e)(3).

⁴¹ Family members include an individual’s spouse, ancestors, lineal descendant’s, brother, brother’s spouse, sister and sister’s spouse. I.R.C. §2704(c)(2).

⁴² See Laurence Keiser, Shielding the Family Limited Partnership from IRS Attacks, The CPA Journal (2009).

⁴³ Treas. Reg. § 25.2704-2(b).

⁴⁴ See *id.*

⁴⁵ See *id.*

years after which the partnership will dissolve;⁴⁶ “any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or any restriction imposed, or required to be imposed, by any Federal or State law” as provided in Section 2704(b);⁴⁷ any restrictions against limited partnerships continuing beyond a certain point in time or the accomplishment of an event;⁴⁸ and any “restriction on the right of a limited partner or a member of an LLC to withdraw from the entity and receive value for his or her interest is not an applicable restriction if state law does not give the limited partner or member such a right at all.”⁴⁹

Various Court challenges to minimize valuation discounts under Section 2704(b) were brought by the IRS with no success. For example, in Kerr v. Comm’r, 113 T.C. 449 (“Kerr”), the Tax Court held that even though there was a transfer of FLP interests to the Kerr’s children, immediately before the transfer the Kerr’s and their children controlled the FLP, and the restrictions were applicable restrictions because the Partnership agreement stated that the FLP will liquidate only on December 31, 2043 or by agreement of all the partners, which limited the FLPs ability to liquidate, Section 2704 still did not apply because the liquidation restrictions were no more restrictive than the state laws that “provides for the dissolution and liquidation of a

⁴⁶ See Kerr v. Comm’r, 113 T.C. 449, 473 (1999) aff’d, 292 F.3d 490 (5th Cir. 2002) (holding that a restriction listing a term of years that the partnership will dissolve by is not an applicable restriction as long as the restriction is less restrictive than state law and the state “law provides for the dissolution and liquidation of a limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners, and the restrictions contained in . . . the partnership agreements are no more restrictive than the limitations that generally would apply to the partnerships under [state] law”.)

⁴⁷ I.R.C. §2704(b)(2)(B).

⁴⁸ See John W. Porter, 41st Annual Heckerling Institute on Estate Planning 7 (2007).

⁴⁹ Louis A. Mezzull, Estate and Gift Tax Audits Luce, Forward, Hamilton & Scripps LLP (2007) <http://www.bcepc.net/Bristol-MA/Library/Suggestions%20for%20estate%20%26%20gift%20tax%20audits.pdf>.

limited partnership pursuant to the occurrence of events specified in the partnership agreement or upon the written consent of all the partners.”⁵⁰

On appeal, the Fifth Circuit Court of Appeals⁵¹ affirmed the Tax Court’s decision that Section 2704 did not apply, but for a different reason. The Court held that there were no applicable restrictions because the University of Texas, a charity, was a third party partner. The Court held that it does not matter that the University of Texas stipulated that it would probably consent to remove the restriction because all that matters is the fact that the University is a non-family member and therefore does not meet the family member requirement in Section 2704(b).⁵²

Court decisions, such as Kerr, and the enactment of restrictive statutes in most states, in effect, have reduced the effectiveness of section 2704(b) for the IRS to disregard liquidation restrictions.⁵³ Therefore, the Obama Budget Proposals for FY 2013 included certain proposals to expand the scope of Section 2704 by creating more categories of disregarded restrictions and thus to further limit valuation discounts those proposals have not as of the date hereof been enacted.⁵⁴ As of the date of this writing, no such provisions have been enacted and the Obama Budget Proposals for FY 2014 did not replicate the proposal.

2. **IRS’s Success Using 2703 to Disregard Restrictions in Determining Valuation**

Unlike with Section 2704(b), the IRS has had some success in challenging to minimize valuation discounts regarding transfers of FLP interests under Section 2703.

⁵⁰ See idId. at 473. See also Estate of Jones v. Comm’r, 116 T.C. 121 (2001) and Knight v. Comm’r, 115 T.C. 506 (2000), have similar facts to Kerr I and the Tax Court also held that § 2704 did not apply because the liquidation restrictions were no more restrictive than the Texas state laws.

⁵¹ Kerr v. Comm’r, 292 F.3d 490 (5th Cir. 2002).

⁵² See Kerr, 292 F.3d 490 at 494.

⁵³ See DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (2012).

⁵⁴ See id.

Section 2703(a)⁵⁵ provides the general rule that a transferor must disregard rights⁵⁶ or restrictions⁵⁷ on property⁵⁸ when valuing such property for estate tax, gift tax, and generation-skipping tax purposes. However, Section 2703(b) gives an exception to this rule of disregarding rights and restrictions when valuing property if each⁵⁹ of the following three requirements are met:⁶⁰ (1) the right or restriction is a bona fide business arrangement; (2) the right or restriction is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and (3) at the time the right or restriction is created, its terms are comparable to similar arrangements entered into by persons in an arm's length transaction.⁶¹

The Statute and Regulations do not define bona fide business arrangement, but case law has determined the following: the maintenance of family ownership and control over

⁵⁵ The provisions of Section 2703 only apply to options and agreements entered into, or substantially modified, after October 8, 1990. The Treasury Regulations provide that "a right or restriction that is substantially modified is treated as a right or restriction created on the date of the modification. Any discretionary modification of a right or restriction, whether or not authorized by the terms of the agreement, that results in other than a de minimis change to the quality, value, or timing of the rights of any party with respect to property that is subject to the right or restriction is a substantial modification. If the terms of the right or restriction require periodic updating, the failure to update is presumed to substantially modify the right or restriction unless it can be shown that updating would not have resulted in a substantial modification. The addition of any family member as a party to a right or restriction (including by reason of a transfer of property that subjects the transferee family member to a right or restriction with respect to the transferred property) is considered a substantial modification unless the addition is mandatory under the terms of the right or restriction or the added family member is assigned to a generation (determined under the rules of § 2651 of the Internal Revenue Code) no lower than the lowest generation occupied by individuals already party to the right or restriction. Treas. Reg. § 25.2703-1(c)(1).

⁵⁶ If property is subject to multiple rights or restrictions then the failure of one right or restriction to meet the exception of § 2703(b) has no effect on any other right or restriction. Treas. Reg. § 25.2703-1(b)(5).

⁵⁷ Rights or restrictions include: (1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (determined without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property. I.R.C. § 2703(a). However, an easement that qualifies for a charitable deduction under Section 2522(d) or Section 2055(f) is not considered a right or restriction under Section 2703. Treas. Reg. § 25.2703-1(a)(4).

⁵⁸ The Court of Appeals for the Fifth Circuit held that property refers to the interests in a Family Limited Partnership, and not the actual assets. Therefore, the partnership form itself is not a restriction that must be disregarded. See Strangi, Estate of v. Comm'r, 293 F.3d 279 (5th Cir. 2002); See also 34B Am. Jur. 2d Federal Taxation ¶ 147,952.

⁵⁹ "The restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for testamentary disposition". Lauder v. Comm'r, 64 T.C.M. 1643 (1992)(emphasis added); See also Treas. Reg. § 25.2703-1(b)(2).

⁶⁰ The exception is met if more than 50% of the property subject to the right or restriction is owned by individuals who are not family members of the transferor. Treas. Reg. § 25.2703-1(b)(3).

⁶¹ I.R.C. § 2703(b).

the business is considered a legitimate business purpose;⁶² and a business does not have to be actively managed to meet the bona fide business requirement.⁶³ However there is no bona fide business arrangement when “a partnership holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy”,⁶⁴ and when the restrictions are for purposes of estate planning, tax reduction, wealth transference, protection against dissipation by the children, and education for the children.⁶⁵

The non-device requirement is a two pronged test. First, the Court first must determine whether a natural object of the transferor’s bounty is benefitting from the transfer. If this is not the case, then there is no issue. However, if a natural object of the transferor’s bounty is benefitting then the Court must move to the second prong and determine if the transfer was for full and adequate consideration.⁶⁶

The following are factors that the courts have used to determine whether the first prong is met and the agreement is a device and a testamentary substitute: the health or age of the decedent when entering into the agreement; the lack of regular enforcement of the agreement; the exclusion of significant assets from the agreement; the arbitrary manner in which the price term was selected, including the failure to obtain appraisals or seek professional advice; the lack of negotiation between the parties in reaching the agreement terms; whether the agreement allowed for adjustments or revaluation of its price terms; whether all the parties to the agreement were

⁶² See St. Louis County Bank v. United States, 674 F.2d 1207, 1210 (8th Cir. 1982); See also Estate of Lauder v. Comm’r, 64 T.C.M. (CCH) 1643 (T.C. 1992); See also Estate of Bischoff v. Comm’r, 69 T.C. 32, 40 (1977).

⁶³ See Estate of Amlie v. Comm’r, 91 T.C.M. (CCH) 1017 (T.C. 2006) (holding that it is a bona fide business when the purpose is to enhance the liquidity of an otherwise illiquid asset).

⁶⁴ See Holman, 601 F.3d 763 at 770; See also Fisher v. U.S., 106 A.F.T.R.2d 2010-611 (S.D. Inc. 2010); See also Steve R. Akers, Holman v. Commissioner; Fisher v. United States, BESSEMER TRUST (October 2010) at 20; and planning for the future needs of decedent’s estate is also considered a business purpose under Section 2703(b)(1). Amlie v. Comm’r, 91 T.C.M. (CCH) 1017, 1026 (T.C. 2006).

⁶⁵ See Holman v. Comm’r, 601 F.3d 763, 772 (8th Cir. 2010).

⁶⁶ See Estate of Gloeckner v. Comm’r, 152 F.3d 208, 214 (2d Cir. 1998).

equally bound to its terms; and any other testimony or evidence highlighting that the agreement supported the decedent's testamentary plan.⁶⁷

The following are considered to be less than full and adequate consideration: when a transferor owns a majority of interests in a Family Limited Partnership, he is considered to have retained the unilateral ability to amend or modify the restrictive provision and as a result, the terms of the restrictive provision are not binding on the transferor and should be disregarded when determining value for Federal gift tax purposes because otherwise it would be a device to obtain a higher valuation discount,⁶⁸ and options that allow transferors to purchase an interest in an entity at less than its pro rata value and redistribute the interests to their other children are considered.⁶⁹ However, a fixed price for a stock interest, whose value is uncertain due to a circumstance such as pending litigation is considered adequate consideration and not a device to transfer to the transferor's bounty for less than full consideration.⁷⁰

Various court challenges to minimize valuation discounts were brought by the IRS prior to 2010. These challenges had no success because the Courts held that preserving a family business,⁷¹ enhancing the liquidity of otherwise illiquid assets,⁷² and even having a restriction that automatically converts shares with voting rights to shares with no voting rights

⁶⁷ See True, 390 F.3d at 1220.

⁶⁸ See Smith v. United States, 02-264 ERIE, 2005 WL 3021918 (W.D. Pa. July 22, 2005).

⁶⁹ See Holman v. Comm'r, 130 T.C. 170, 197 (2008) aff'd, 601 F.3d 763 (8th Cir. 2010).

⁷⁰ See Alden Koste, The IRS Fished Its Wish; The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in Holman v. Commissioner, 59 CATH. U. L. REV. 289, 305 (2009).

⁷¹ See Church v. U.S., 85 A.F.T.R.2d 2000-804 (W.D.Tex.), aff'd, 268 F.3d 1063 (5th Cir. 2001), (where an FLP was created mainly to preserve the family's ranch as a family business. The partnership agreement contained term restrictions and restrictions on the sale of the partnership interests. In a favorable opinion for the taxpayer, the Court held that these restrictions could be considered in the valuation of Mrs. Church's partnership interests, and § 2703(b) was satisfied, because these restrictions are part of the property interest itself).

⁷² See Estate of Amlie v. Comm'r, 91 T.C.M. (CCH) 1017 (T.C. 2006) (where the decedent's family put a right or restriction, through a settlement agreement, on the price of the decedent's stock due to uncertainty of the stock's value. The Tax Court held that this restriction should not be disregarded because the safe harbor of § 2703(b) was met. The Court held that (1) this was a bona fide business arrangement because the purpose was to enhance the liquidity of an otherwise illiquid asset, (2) this was not a device to transfer the property to the decedent's family for less than full and adequate consideration because the value was uncertain due to pending litigation, and (3) it was comparable to similar arrangements entered into in arm's length transaction because the family was able to show a similar agreement from 1994 that has similar terms).

upon a sale of the stock⁷³ are all considered business purposes in order to meet the safe harbor of Section 2703(b). However, in 2010 the Courts upheld the IRS's challenges that Section 2703 should be used to minimize valuation discounts when the FLP's only asset is publicly traded stock and there is no specific investment strategy.⁷⁴

DEFINED VALUATION CLAUSES: GENERALLY

Transfers of real estate, or interests in entities that own real estate, raise many difficult valuation challenges. One of the principal advantages of the grantor retained annuity trusts under section 2702 is that if there is a valuation challenge, the annuity is allowed to self adjust as the annuity amount is stated as a percentage of the assets transferred, not a fixed dollar amount. Thus, an inadvertent gift tax will not arise. Other techniques have historically been at a disadvantage since there were questions as to whether such a self-adjustment mechanism would be respected by the IRS. More recently, the cases have recognized the efficacy of certain types of valuation clauses. This respect for properly structured valuation clauses has taken a significant risk factor out of planning for difficult to value assets – such as real estate and interests in entities that hold real estate.

A defined valuation clause is used to minimize valuation uncertainty in connection with transfer tax planning.⁷⁵ In order to accomplish this, a donor must maximize his/her exemptions and credits. The exemption that has received the most judicial scrutiny is the lifetime gift tax exemption,⁷⁶ which allows the donor to make gifts up to the amount of the gift

⁷³ See Estate of Smith v. United States, 07-676T, 2012 WL 591506 (Fed. Cl. Feb. 13, 2012) (holding that this is not a restriction on “property and cannot be sold separately from the underlying stock. Therefore, there [can] not be a sale of the enhanced voting rights, only a sale of the stock to which those rights related”).

⁷⁴ See Holman v. Comm’r, 130 T.C. 170, aff’d, 601 F. 3d 763, 772 (8th Cir. 2010); See also Fisher v. U.S., 106 A.F.T.R.2d 2010-611 (S.D. Inc. 2010)

⁷⁵ The transfer of property during lifetime is subject to gift tax. See I.R.C. § 2512.

⁷⁶ See Scott A. Bowman, McCord v. Commissioner; Defined Value Clauses Redefined?, 33 ACTEC J. 169, 171 (2007). See Bowman, supra note 1, at 171.

tax exemption (\$5,120,000 for 2012), without having to pay any gift tax.⁷⁷ However, this would also apply to the annual gift tax exclusion and other credits and exemptions. When a donor wants to make a gift of cash, it is simple to figure out the amount that s/he can give without incurring any tax liability. However, when a donor wants to transfer an interest in a closely held corporation or family limited partnership, it is much more difficult to value the amount of the gift for gift tax purposes because the underlying value of the interests transferred are not readily marketable.

There are two principal types of defined valuation clauses: formula transfer clauses and formula allocation clauses, the latter of which is favored by the Courts.⁷⁸ The first type is a savings clause, which is also known as a formula transfer clause, and limits the amount transferred. For example, a taxpayer may transfer to the trustees of a trust a fractional share of the property (where the fractional share is determined by a formula) and require that if the IRS finds a higher value that the excess be returned to the donor or deems that excess not to have been transferred in the first instance.⁷⁹ The second type is a “formula allocation clause” which completely transfers an asset, but allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees include charities, spouses, QTIP trusts, “incomplete gift trusts” (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and “zeroed-out” GRATs. With this second type of clause, the allocation can be based on values as finally

⁷⁷ See I.R.C. § 2505(a)(1), as amended by 2010 Tax Relief Act §301(b)(1)(A).

⁷⁸ See Hamid M. Pour, Formula and Defined Value Clauses – the Fight against the IRS’s Public Policy Arguments, (2010).

⁷⁹ See *id.*

determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values.⁸⁰

Formula transfer clauses may be easier to administer, but the Courts have favored formula allocation clauses. We can infer from Christiansen and Petter⁸¹ that formula allocation clauses are favored, especially where there is a third party who is adverse to a lower valuation, such as a charity, because (1) the Christiansen Court's main rationale for allowing such clauses is that there are mechanisms to ensure that values are accurately reported, and it is therefore not contrary to public policy and (2) the Petter Court states that they look negatively on a clause that tries to give property back to the donor.⁸²

The courts have validated two different approaches to formula allocation clauses: the McCord-Confirmation Agreement Approach and the Petter-Finally Determined Gift Tax Value Approach. The first approach was used in McCord and Hendrix to allocate the shares based on a confirmation agreement among the transferees. The advantages of the confirmation agreement approach are that the transferees decide how much they receive,⁸³ and the value is determined quickly.⁸⁴ The second approach was used in Christiansen and Petter to allocate the block of transferred assets based on values as finally determined for estate or gift tax purposes. There may be more certainty regarding the validity of these types of clauses, but disadvantages are that the transferees are not negotiating how much they receive and the value is not determined for a long time.⁸⁵

⁸⁰ See Petter – Defined Value Clause Upheld; “One-Two Punch” to IRS’s Fight Against Defined Value Clauses (LEIMBERG INFO. SERVS., INC.), Jan. 14, 2010.

⁸¹ See supra pp. 23-24.

⁸² See Petter v. Comm’r, 653 F.3d 1012, 1022 (9th Cir. 2011); See also Petter, supra note 183.

⁸³ See Steve R. Akers, Defined Value Clause Updates Hendrix and Petter (2011).

⁸⁴ See Id.

⁸⁵ See id.

1. **Judicial Background of the Validity of Defined Valuation Clauses**

Until recently the IRS had been successful in challenging the validity of defined valuation clauses.⁸⁶ For example, in Comm’r v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), the Fourth Circuit Court of Appeals held that a clause in a trust indenture⁸⁷ stating that if any federal court of last resort determined that any part of the transfer was subject to gift tax then the gift portion would not be included in the transfer and would remain in the donor’s estate is not valid because it is a condition subsequent that violated public policy because it discourages the collection of tax, obstructed the administration of justice by requiring the court to pass on a moot case and caused any court opinion to be a mere declaratory judgment.⁸⁸

However, beginning in 2006 the Courts started to give effect to defined valuation clauses. In McCord v. Comm’r,⁸⁹ 461 F.3d 614 (5th Cir. 2006), rev’d, 120 T.C. 358 (2003), the Fifth Circuit Court of Appeals gave effect to a formula allocation clause,⁹⁰ but did not discuss the public policy argument. Then, in Christiansen v. Comm’r, 586 F.3d 1061 (8th Cir. 2009), the

⁸⁶ See, e.g., Ward v. Comm’r, 87 T.C. 78 (1986); Harwood v. Comm’r, 82 T.C. 239 (1984), aff’d, 786 F.2d 1174 (9th Cir. 1986).

⁸⁷ A trust indenture is an agreement in the bond contract made between a bond issuer and a trustee that represents the bondholder’s interests by highlighting the rules and responsibilities that each party must adhere to. *Trust Indenture*, INVESTOPEDIA (2012).

⁸⁸ The IRS, in Revenue Ruling 86-41, 1986-1 T.C. 300, also refused to recognize two different types of valuation adjustment clauses contained in a deed of a gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to \$10,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount equal to the excess of the value of the property over \$10,000, as determined by the IRS. The IRS rejected both of those provisions because Rev. Rul. 65-144, 1965-1 C.B. 442, states that this would defeat the purpose of the gift tax provisions.

⁸⁹ See also Hendrix v. Comm’r, 101 T.C.M. (CCH) 1642 (T.C. 2011) (where Tax Court held consistently with McCord that a formula gift clause, in a gift to a family trust where the excess passes to a charitable donee, works where the clause limits the size of the portion of a transfer of stock passing to trusts for the transferors’ descendants to a set amount while any excess value was to be transferred to a community foundation because (1) the gift agreement was negotiated at arm’s length because the trusts assumed economic and business risk and where therefore at odds with the petitioner and the charitable donee and (2) the clause did not violate public policy because public policy is to encourage giving gifts to charity, which is consistent with Christiansen).

⁹⁰ In McCord v. Comm’r, 461 F.3d 614 (5th Cir. 2006), rev’g, 120 T.C. 358 (2003), the Fifth Circuit Court of Appeals held that the formula allocation clause in a gift that was based on a confirmation agreement between the donees was the necessary measurement for determining the value of the gifts.

Eighth Circuit Court of Appeals rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit,⁹¹ and in Petter v. Comm’r, 653 F.3d 1012 (9th Cir. 2011), the Ninth Circuit Court of Appeals affirmed the Tax Court’s ruling that formula allocation provisions are not void as contrary to public policy in an inter vivos gift/sale transaction.⁹² Taken together these cases validate defined valuation clauses for gift and estate tax purposes. However, defined valuation clauses that involve a condition subsequent in which the donor tries to take property back based on IRS redetermination still do not work.

The most recent decision to uphold defined valuation clauses is Wandry v. Comm’r, 103 T.C.M. (CCH) 1472 (T.C. 2012), where the Tax Court held that a defined valuation clause was valid even where there was no charitable donee receiving any part of the property. By doing so, the “Tax Court reconfirmed the distinction between the type of clause used in Procter (which is void because it involves a condition subsequent (i.e., the IRS redetermination) and the type of defined value clauses upheld in the more recent cases (which relies on a ‘condition precedent’ to transfer a ‘fixed set of rights with uncertain value’). Although the IRS initially filed a notice of appeal with respect to the Tax Court decision in Wandry, it was subsequently withdrawn. The IRS has since published a nonacquiescence, meaning that the IRS will not follow the Wandry Tax Court opinion.⁹³

⁹¹ The court gave three reasons: (1) The IRS’s role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent expressing a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported.

⁹² The Tax Court held that formula allocation clauses are not contrary to public policy because public policy encourages charitable gifts, the allocation clauses would be implemented fairly, the case involves a real issue and not just a declaratory judgment, and other regulations allow different types of formula clauses.

⁹³ See Wandry v. Comm’r, 103 T.C.M. (CCH) 1472 (T.C. 2012), nonacq., 2012-46 (Nov. 13, 2012).

GIFT TAX EXCLUSION

Historically, annual exclusion gifts⁹⁴ provided a method to seed estate planning transactions. Especially for those with large families, and with the use of “Crummy” powers, the annual exclusion would be a vehicle for funding a trust which could eventually enter into a leveraged estate planning transaction. Today, with the higher lifetime exemptions, there is less emphasis on using annual exclusion gifts for this purpose. Moreover, recent case law has raised question as to the viability of gifting of interests in family limited partnerships and limited liability companies to qualify for the annual exclusion. While they are not totally out of use, they are much less favored. Instead, the tendency is to use the annual exclusion to make cash gifts for incidental items and to use the lifetime exemption for the larger interests.

Nevertheless, for those situations where annual exclusion gifting of interests in family partnerships and limited liability companies is still contemplated, care must be exercised in structuring the gift to avoid the pitfalls that have arisen in recent cases. These cases are discussed below.

1. Historical Background of Gifts of Limited Partnership Interests Qualifying for the Annual Gift Tax Exclusion

Historically gifts of a limited partnership interest were widely considered to be a present interest as long as it was transferred outright and not through a conduit of a trust. Even the IRS generally gave favorable rulings regarding the allowance of FLP interests qualifying for the annual gift tax exclusion.⁹⁵ However, in the early 2000’s this trend began to change as the

⁹⁴ Section 2503(b) gives a taxpayer an annual gift tax exclusion for gifts of present interests. The exclusion, currently at \$14,000 per year per donee (\$28,000 if the donor is married and elects to split gifts with his/her spouse), is adjusted for inflation and does not count towards the gift tax exemption of \$5,250,000. Section 25.2503-3(a) provides that future interests include “reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.” Section 25.2503-3(b) provides that a present interests is an “unrestricted right to immediate use, possession, or enjoyment of property or the income from property”.

⁹⁵ See, e.g., I.R.S. TAM 8611004 (Nov. 15, 1985), I.R.S. TAM 9131006 (Aug. 2, 1991), TAM 9415007 (Jan. 12, 1994), TAM 199944003 (July 2, 1999).

Courts held that certain requirements must be met in order for a gift of a limited partnership interest to be considered a present interest. For example, the Courts in Hackl,⁹⁶ Price,⁹⁷ and Fisher⁹⁸ held that there was no present interest, and therefore no annual gift tax exclusion allowed, where the donor transferred the interests to his/her children when (i) the operating agreements had too many restrictions on the transferability of limited partnership interests (and therefore did not give the donees a substantial present economic benefit from the actual limited partnership interests) and (ii) the limited partnership did not meet the three pronged test of (1) that the limited partnership would generate income at or near the time of the gifts, (2) that some portion of that income will flow steadily to the donees, and (3) that the portion of income flowing to the donees can be ascertained (and therefore there was no substantial present economic benefit from the income from the partnership interests). However, there would have been a present interest if the requirements had been met. For example, in Wimmer v. Comm’r, T.C.M. (RIA) 2012-157 (T.C. 2012), the Tax Court held that a donor can qualify for the annual gift tax exclusion when the FLP holds publicly traded and dividend paying stock, some portion of the Partnership income was expected to flow steadily to the limited partners based on the fiduciary obligations of the general partners, and the stock was publicly traded so the limited partners could estimate their allocation of quarterly dividends on the basis of the stock’s dividend history and their percentage ownership in the partnership, because the donee has a present interest in the income from the FLP interests.

Based on the aforementioned cases the following considerations should help ensure that gifts of FLP interests constitute present interests and qualify for the annual gift tax exclusion: avoid gifts of FLP interests themselves, and rather gift the property that will be placed

⁹⁶ See Hackl v. Comm’r, 335 F.3d 664 (7th Cir. 2006), aff’g, 118 T.C. 279 (2002).

⁹⁷ See Price v. Comm’r, T.C.M. (RIA) 2010-002 (T.C. 2010).

⁹⁸ See Fisher v. United States, 1:08CV0908-LJM-TAB, 2010 WL 935491 (S.D. Ind. Mar. 11, 2010).

in the FLP, give the donees Crummey powers, so that at least part of the gift will be considered a present interest, use put rights which allow the donee to sell the interest and therefore give them a present interest, give income-producing property and/or make regular distributions to the donees, and avoid very restrictive agreements regarding the transferability of the interests.⁹⁹

REAL ESTATE HOLDINGS ARE ILLIQUID – METHODS OF DEFERRING ESTATE TAX PAYMENTS

One of the greatest difficulties in planning for real estate owners is that the real estate tends to be highly illiquid. The estate of the high net worth real estate owner may lack the funds to pay the estate taxes imposed upon what may be very significant values. Unlike the holder of a portfolio of marketable securities and cash, the real estate owner may not be able to readily raise the cash to pay an estate tax without incurring heavy losses through a fire sale. While there exists possibilities such as refinancing and life insurance planning, these options may not always be available and may be very costly. Moreover, even if they are available, there may be a desire to use these options for future needs of the business. Therefore, it is often necessary to rely upon methods to defer the payment of estate taxes.

Note the availability of section 6166 deferral may be a central consideration in planning for the real estate client. In that regard, planning with IDGTs may impact the availability of section 6166 to the estate. For example, if active real estate assets are sold to a grantor trust in exchange for an installment note, the installment note is not considered an interest in an actively managed trade or business while the real estate may have been. Thus, if a major portion of the estate is comprised of real estate assets that would otherwise qualify for deferral of estate taxes under section 6166, the overuse of the installment sale to the IDGT could

⁹⁹ See Robert W. Malone & Jon R. Stefanik, Fisher and Price: The End of Annual Exclusion Gifts of FLP Interests, or Mere Child's Play?, TAXES-THE TAX MAGAZINE, Oct. 2011, at 28.

preclude section 6166 if real estate assets were transferred to an irrevocable trust in exchange for promissory notes which do not constitute the type of assets that qualify for such deferral.

There are three types of deferral listed in the Internal Revenue Code that allow a taxpayer to defer estate taxes beyond nine months after the date of death.¹⁰⁰ The first type of deferral is allowed when the executor can show reasonable cause or undue hardship.¹⁰¹ The second type of deferral is allowed when the estate consists of reversionary or remainder interest.¹⁰² The third type of deferral is allowed when a significant portion of the estate consists of an interest in a closely held business.¹⁰³

1. First Type of Deferral: Section 6161 Reasonable Cause/Undue Hardship Deferral

Section 6161 allows an estate to defer estate taxes for up to 12 months if the executor can show reasonable cause or up to 10 years if s/he can show undue hardship. The requirements for the § 6161 deferral are broader than the § 6166 deferral as there is no requirement that the business must be closely held, there are no penalties for acceleration, there are no percentage requirements, and there are no active business requirements.¹⁰⁴

The Treasury Regulations provide the following factors to be used to show reasonable cause and allow an estate to defer estate taxes for up to 12 months: the executor does not have control of the estate's liquid assets; a substantial part of the assets are comprised of rights to receive payments in the future (i.e. annuities, copyright royalties, contingent fees, or accounts receivable); a substantial part of the assets consists of assets that cannot be collected

¹⁰⁰ See HAROLD WEINSTOCK & MARTIN NEUMANN, PLANNING AN ESTATE 36 (Thomson Reuters/West, 2010).

¹⁰¹ I.R.C. § 6161.

¹⁰² I.R.C. § 6163.

¹⁰³ I.R.C. § 6166.

¹⁰⁴ See LEAH LAPORTE, Keeping The Farm: Estate Tax Deferral And Closely Held Business Owners, 41 COLUM. J.L. & SOC. PROBS. 177, 203 (2007).

without litigation; or an estate has insufficient funds to pay the estate tax and has made reasonable efforts to convert the assets into cash.¹⁰⁵

Undue hardship is more difficult to demonstrate than reasonable cause, and a general statement of hardship or an inconvenience to the estate is not enough. The Treasury Regulations provide two examples that illustrate undue hardship. One example is where a closely held business comprises a significant portion of an estate, but the percentage requirements of § 6166(a)¹⁰⁶ are not satisfied. The second example is that the assets must be sold at a sacrifice price or in a depressed market in order to pay the estate tax.¹⁰⁷

The Treasury Regulations provide that an application for extension based on reasonable cause or undue hardship must be filed with the appropriate district director, who has the discretion to decide if and for how long a deferral is needed, on or before the date fixed for the payment of tax.¹⁰⁸ If an extension is granted under Section 6161(a)(2) then interest is computed from the due date of the tax return to the date of payment.¹⁰⁹

2. **Second Type of Deferral: Section 6163 Reversionary or Remainder Interest Deferral**

Section 6163 provides that if the value of a remainder or reversionary interest is included in the estate then the executor may postpone the payment of the estate tax attributable to

¹⁰⁵ Treas. Reg. § 20.6161-1(a)(1), examples 1-4.

¹⁰⁶ Treas. Reg. § 20.6161-1(a)(1).

¹⁰⁷ Treas. Reg. § 20.6161-1(a)(2).

¹⁰⁸ An application containing a request for an extension of time for paying the tax shown on the return shall be in writing, shall state the period of the extension requested, and shall include a declaration that it is made under penalties of perjury. If the application is based upon reasonable cause, a statement of such reasonable cause shall be included in the application. If the application is based upon undue hardship to the estate, the application shall include a statement explaining in detail the undue hardship to the estate that would result if the requested extension were refused. At the option of the executor, an application for an extension of time based upon undue hardship may contain an alternative request for an extension based upon reasonable cause if the application for an extension based upon undue hardship is denied. Treas. Reg. § 20.6161-1(a)(2).

¹⁰⁹ See IRS Manual 20.2.10.1, http://www.irs.gov/irm/part20/irm_20-002-010.html.

such interest until six months after the termination of the precedent interest. For reasonable cause, an executor may extend this period for up to an additional three years.¹¹⁰

The Treasury Regulations provide that notice of the exercise of the election to postpone the payment of the tax attributable to a reversionary or remainder interest should be filed with the district director before the date prescribed for payment of the tax. The notice of election may be made in the form of a letter addressed to the district director. There shall be filed with the notice of election a certified copy of the will or other instrument under which the reversionary or remainder interest, was created, or a copy verified by the executor if the instrument is not filed of record.¹¹¹

If a deferral is granted under Section 6163, then interest is computed on the portion that is deferred from the due date of the return to the date that it is paid.¹¹²

3. **Third Type of Deferral: Section 6166 Closely Held Business Deferral**

Section 6166 was designed by Congress to create a safety valve to protect the integrity of illiquid closely held business interests of a decedent from the type of liquidity crisis that can result from the imposition of the estate tax. It does not reduce the amounts ultimately payable but it defers the obligation significantly. It provides, in summary, that in those instances in which a substantial part of a decedent's gross estate consists of a closely-held business venture, which the decedent had conducted in his lifetime, his personal representative may elect to pay that portion of federal estate tax which is attributable to that venture in equal annual installments over a period of time not to exceed ten years. The Section also provides that a personal representative may elect to defer payment of the first annual installment for a period not to exceed five years. During that deferment period, interest on the deferred tax is payable annually at a nominal rate¹¹³ fixed by the statute.¹¹⁴

¹¹⁰ See I.R.C. § 6163.

¹¹¹ Treas. Reg. § 20.6163-1(b).

¹¹² See IRS, *supra* note 254.

¹¹³ I.R.C. § 6601(j)(1)(A) and (B).

¹¹⁴ See *Parrish v. Loeb*, 558 F. Supp. 921, 923 (C.D. Ill. 1982).

Only the estate tax attributable to the closely held business may be deferred and paid in installments. This amount is determined by the ratio that the closely held business amount bears to the amount of the adjusted gross estate.¹¹⁵ The interest then accrues at a rate of 2% per year on estate tax attributable to the first \$1,000,000 of taxable business value, adjusted for inflation.¹¹⁶ The interest rate payable on the balance of the deferred estate tax is equal to 45% of the regular underpayment interest rates in Section 6601(a).¹¹⁷ The interest payments are not deductible for either income tax or estate tax purposes.

The irrevocable election to pay the tax in installments must be made within the time for filing the estate tax return, which is nine months from the date of death.¹¹⁸ The first installment does not have to be paid on the exact date that the original tax was due, but it must be paid on the same day of the month as the original tax was due, with the remaining installments now due by this new date.¹¹⁹

The § 6166 election is more advantageous to the estate than the § 6161 election because it offers a 2% interest rate, has a longer deferral period, and you do not have to rely solely on the Secretary to decide the deferral period.¹²⁰

a. **Four Section 6166 Requirements**

There are four requirements that the estate must meet in order to qualify for a Section 6166 deferral. The first requirement is that the decedent must have been a citizen or resident of the United States at the date of death.¹²¹

¹¹⁵ See I.R.C. § 6166 (a)(2).

¹¹⁶ I.R.C. § 6601(j)(1)(A).

¹¹⁷ I.R.C. § 6601(j)(1)(B).

¹¹⁸ See I.R.C. § 6166 (d).

¹¹⁹ See STEFAN F. TUCKER & MARY A. MANCINI, 14th ANNUAL REAL ESTATE TAX FORUM 91 (2d Vol. 2011).

¹²⁰ See Laporte, *supra* note 249, at 205.

¹²¹ See I.R.C. § 6166 (a)(1).

The second requirement is that the value of the closely held business must be at least 35% of the value of the adjusted gross estate.¹²² When the estate owner owns more than one business, the value of each business in which the decedent owns at least a 20% interest may be aggregated to satisfy the 35% rule.¹²³ No attribution of family member's interest is allowed to help the decedent meet the 35% requirement.

The third Section 6166 requirement is that the interest must be in a business that is closely held,¹²⁴ which can be satisfied if the decedent is one of the following: a sole proprietor; a partner in a partnership with no more than 45 partners, or where at least 20% or more of the capital interest in the partnership is owned by the decedent; or a shareholder in a corporation with no more than 45 shareholders, or where 20% of the voting stock of the corporation is owned by the decedent.¹²⁵ In determining whether there are 45 or fewer partners or shareholders, all partnership or stock interests owned by the decedent's brothers, sisters, spouse, ancestors, and lineal descendants are deemed owned by the decedent.¹²⁶ In determining whether the 20% test is met, the decedent is deemed to own all partnership or stock interests owned by the decedent's brothers, sisters, spouse, ancestors, and lineal descendants.¹²⁷ This is called family attribution.

¹²² See *id.*

¹²³ See I.R.C. § 6166 (c).

¹²⁴ See I.R.C. § 6166 (a)(1).

¹²⁵ § 6166(b)(1) Interest in closely held business

For purposes of this section, the term "interest in a closely held business" means—

(A) an interest as a proprietor in a trade or business carried on as a proprietorship;

(B) an interest as a partner in a partnership carrying on a trade or business, if—

(i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or

(ii) such partnership had 45 or fewer partners; or

(C) stock in a corporation carrying on a trade or business if—

(i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or

(ii) such corporation had 45 or fewer shareholders.

¹²⁶ § 6166(b)(2)(D) Certain interests held by members of decedent's family

All stock and all partnership interests held by the decedent or by any member of his family [within the meaning of section [267 \(c\)\(4\)](#)] shall be treated as owned by the decedent.

¹²⁷ See *id.*

There is a penalty for using the family attribution rules. The estate loses the five year deferral of principal and there is no 2% interest portion.¹²⁸

The fourth requirement is that the trade or business must be active, rather than passive. The Revenue Rulings have held that management of investment-type activities generally do not generally constitute a trade or business.¹²⁹ In the 1970s and 1980s the IRS issued rulings, and the Courts held, that the rental of real estate without an owner having any active duties does not qualify for the § 6166 deferral.¹³⁰ However, if the lease of the real estate is subject to a crop sharing arrangement where the rent is based on the productivity of the farm and not a passive fixed rental, then § 6166 would apply.¹³¹

In 2006 the IRS provided clarity regarding what the active duty requirement meant. The ruling lists non-exclusive factors that will be looked at when determining whether a business is active, including: the amount of time devoted to the business; whether the owner maintained an office to perform the activities and has regular business hours specifically for that purpose; how involved the owner was in actively finding new tenants and negotiating and executing leases; the owner's involvement in services, such as landscaping, grounds care, or

¹²⁸ § 6166(b)(7) Partnership interests and stock which is not readily tradable

(A) In general

If the executor elects the benefits of this paragraph (at such time and in such manner as the Secretary shall by regulations prescribe), then—

(i) for purposes of paragraph (1)(B)(i) or (1)(C)(i) (whichever is appropriate) and for purposes of subsection (c), any capital interest in a partnership and any non-readily-tradable stock which (after the application of paragraph (2)) is treated as owned by the decedent shall be treated as included in determining the value of the decedent's gross estate,

(ii) the executor shall be treated as having selected under subsection (a)(3) the date prescribed by section [6151 \(a\)](#), and

(iii) for purposes of applying section [6601 \(j\)](#), the 2-percent portion (as defined in such section) shall be treated as being zero.

¹²⁹ See Rev. Rul. 75-366, 1975-2 C.B. 472, Rev. Rul. 2006-34, 2006-26 I.R.B. 1171.

¹³⁰ See Smith v. Booth, 823 F.2d 94 (5th Cir. 1987, rev'g, A-84-CA-577, 1986 WL 83455 (W.D. Tex. Aug. 27, 1986) (holding that a net cash lease arrangement of real estate, where the owner has no duties, is considered a passive activity, and therefore does not qualify for the deferral); See also I.R.S. Priv. Ltr. Rul. 80-20-101 (Feb. 25, 1980) (where the IRS ruled that the property did not qualify under § 6166 when there was a lease agreement, from a parent to her children, that the children would pay all the taxes and maintenance expenses); See also Rev. Rul. 75-367, 1975-2 C.B. 472.

¹³¹ See Rev. Rul. 75-366, 1975-2 C.B. 472.

other services beyond the mere furnishing of leased premises; the extent to which the owner personally made, arranged for, performed, or supervised repairs and maintenance to the property, including without limitation painting, carpentry, and plumbing; and the extent to which the owner handled tenant repaid requests and complaints.¹³²

The Ruling then applied the list of factors to five examples and held that there is an active trade or business when: an individual owns a strip mall and is responsible for the day to day work, but occasionally hires an independent contractor when he cannot do the work; an individual hires a property management company in which he had a 20% interest, which is a significant interest; a Partnership hires a general partner, with even a 1% interest, to perform management functions; and an individual owns 100% of the stock of a closely held business and the business conducts an active trade or business, and even the property leased to the business is available for the deferral as long as it is also used in the active trade or business, but there is no active trade or business when; an individual hires a property management company in which he had no interest.¹³³

The IRS has ruled that if an agent takes over the active management of the real estate due to the owner's lack of health, regardless of whether the agent is a family member or a third party, then a deferral is available.¹³⁴ The IRS has also ruled that if someone, who is not sick, owns an apartment building portfolio that is managed by a third party then it can be considered an active business, regardless of whether the agent is a family member or a third party, if (i) he/she also owns an interest in the management company or (ii) he/she still performs some of the services. Otherwise, it is considered a passive interest.¹³⁵

¹³² See Rev. Rul. 2006-34, 2006-1 C.B. 1171.

¹³³ Id.; See also NAVIGATING THE WATERS OF ESTATE TAX DEFERRAL AND PAYMENT TECHNIQUES IN ILLIQUID ESTATES, SP053 ALI-ABA 347 , 357-61

¹³⁴ See I.R.S. Priv. Ltr. Rul. 81-34-018 (May 1, 1981); See also I.R.S. Priv. Ltr. Rul. 81-34-012 (Apr. 30, 1981).

¹³⁵ See Rev. Rul. 2006-34, 2006-1 C.B. 1171.

If a closely held business engages in both active and passive activities then only the value of the active business may be used to determine the percentage requirements, unless, as provided in I.R.C. § 6166(b)(9) “[i] a corporation owns 20 percent or more. . .of the voting stock of another corporation or [the] other corporation has 45 or fewer shareholders, and [ii] 80 percent or more of the value of the assets of [the other] corporation is attributable to assets used in carrying on a trade or business”.¹³⁶

b. Four Types of Section 6166 Deferrals

There are 4 types of § 6166 deferrals. The first type is the Section 6166(a) deferral, which is available for operating companies, partnerships, sole proprietors, and LLCs. If the estate meets the requirements of Section 6166(a), then the estate can defer payment of principal for five years and then pay it in up to ten annual installments, but must pay the following interest rates; (i) 2% on the deferred tax attributable to the first \$1,000,000, (ii) 45% of the regular underpayment interest rates on the remaining deferred tax, and (iii) a penalty rate of 5% on the amount of the payment for each month it was overdue if late payments are made within six months of the due date.

The second type is the Section 6166(b)(7) deferral, which can be elected if the decedent did not own enough to meet the percentage requirements of Section 6166(a), but is able to meet the percentage requirements through family attribution. When this type of deferral is elected the estate loses the preferential rate of 2% on the first \$1,000,000 and the five-year deferral of principal payments, and must pay 45% of the regular underpayment interest rates on the full deferred amount.¹³⁷

¹³⁶ I.R.C. § 6166 (b)(9).

¹³⁷ See I.R.C. § 6166 (b)(7).

The third type is the Section 6166(b)(10) deferral, where stock in qualifying lending and finance businesses is treated as stock in an active trade or business company.¹³⁸ Here, the estate must pay the following interest rates; (i) 2% on the deferred tax attributable to the first \$1,000,000, (ii) 45% of the regular underpayment interest rates on the remaining deferred tax, and (iii) a penalty rate of 5% on the amount of the payment for each month it was overdue on late payments paid within six months of the due date.¹³⁹

The fourth type is the Section 6166(b)(8) deferral which is a holding company election available for a business that owns stock in another business.¹⁴⁰ In order to qualify for this type of deferral the executor must make an election,¹⁴¹ the holding company's interest must meet the requirements of Section 6166(b)(1)(C); and the interest must exceed 35% of the gross estate.¹⁴² If this election is made, then the 5 year deferral for principal payments and the 2% interest rate do not apply.¹⁴³

A holding company can also qualify for a deferral under Section 6166(b)(9)(B)(iii) if the corporation owns at least 20% of the subsidiary or the subsidiary has less than 45 employees and at least 80% of the value of the subsidiary is attributable to assets used in carrying on a trade or business.¹⁴⁴

An issue relevant to the Section 6166(b)(8) deferral is that the statute defines a holding company as “any corporation holding stock in another corporation”¹⁴⁵ and it is unclear as to how Section 6166(b)(8) applies to partnership and LLC holding companies. This was not a big

¹³⁸ See I.R.C. § 6166 (b)(10). Nelson M. Blakely, The 4 Types of Section 6166 Deferrals, SECTION 6166 (October 25, 2011), http://www.section6166.com/index.php?option=com_content&view=article&id=85&Itemid=67

¹³⁹ I.R.C. § 6166 (b)(10).

¹⁴⁰ See DENNIS I. BELCHER, 39th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING 5-22 (2005).

¹⁴¹ See I.R.C. § 6166 (b)(8)(A).

¹⁴² See I.R.C. § 6166 (a)(1).

¹⁴³ See I.R.C. § 6166 (b)(8)(A).

¹⁴⁴ See I.R.C. § 6166 (b)(9)(A)(iii).

¹⁴⁵ I.R.C. § 6166(b)(8)(emphasis added).

issue when Section 6166 was enacted because most closely held businesses were organized as corporations, but now the issue has come to the fore because LLCs and LLPs are much more common, and even preferred. Congress did not intend for the amendments to penalize companies because of their choice of entity.¹⁴⁶ Therefore, the American Bar Association has proposed that Congress modify Section 6166(b)(8) to apply consistent criteria regardless of the choice of entity, and include a uniform definition of a closely held business.¹⁴⁷

c. Three Ways in which Section 6166 Benefits are Lost

There are three ways in which the estate can lose its § 6166 benefits and be forced to make accelerated deferred payments. The first type of acceleration occurs when the estate distributes, sells, exchanges or otherwise disposes of 50% or more of the value of the closely held business interest.¹⁴⁸ When this happens the estate must pay the entire unpaid portion.¹⁴⁹ The following actions are not considered to be dispositions: certain redemptions of stock to pay death tax under § 303,¹⁵⁰ changes in form of doing business,¹⁵¹ certain tax-free exchanges of stock in connection with reorganizations, under § 368 (a)(1)(D), (E) or (F) and § 355,¹⁵² a transfer of property of the decedent to a person entitled to receive the property under the decedent's will, the applicable law, or a trust created by the decedent,¹⁵³ and the funds received

¹⁴⁶ See Dennis I. Belcher, Outside the Box on Estate Tax Reform: Reviewing Ideas to Simplify Planning, 41 REAL PROP. PROB. & TR. J. 73 (2006) (citing S. REP. NO. 98-369).

¹⁴⁷ See Memorandum from the Sections of Taxation and Real Property Trusts, & Estates Law of the American Bar Association Task Force (Apr. 4, 2012) *available at* <http://www.americanbar.org/content/dam/aba/administrative/taxation/040512letter.authcheckdam.pdf>.

¹⁴⁸ See I.R.C. § 6166 (g)(1).

¹⁴⁹ "Acceleration of payments is not automatic. If an estate triggers one of these acceleration clauses, the tax liability is only due upon notice and demand from the Service. *Lake Shore Nat'l Bank v. Coyle*, 419 F.2d 958 (7th Cir. 1969)." Laporte, *supra* note 249, at 200.

¹⁵⁰ See I.R.C. 6166(g)(1)(B).

¹⁵¹ See Reg. § 20.6166A-3(e)(2).

¹⁵² See I.R.C. 6166(g)(1)(C).

¹⁵³ See I.R.C. 6166(g)(1)(D).

in a sale of a portion of the assets of a closely held business and used to pay the mortgage and prevent foreclosure of the business property.¹⁵⁴

The second type of acceleration occurs when the estate has undistributed net income. When this happens the estate must pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments.¹⁵⁵

The third type of acceleration occurs when the estate fails to make a timely payment of principal or interest. When this happens the estate must pay the entire unpaid portion. However, if the estate makes late payments within six months of the due date then there is no acceleration, however the estate is subject to penalties of 5% for each month it was not paid and loss of the 2% interest rate.¹⁵⁶

d. Government Lien to Secure the Section 6166 Deferred Estate Tax

Section 6324(a) gives the government a general federal estate tax lien on the assets of a decedent's gross estate, but only lasts for ten years. This is an issue because under Section 6166 an executor can elect to pay the estate tax over a fourteen-year period, which leaves a period that the government has no lien. Therefore, Sections 6166(k)(1) and 6165 allow the IRS to require a surety bond, or gives the IRS a special lien that covers the duration of the deferral.¹⁵⁷

In 2002 the IRS started to require a surety bond, or a special lien before an executor can elect a § 6166 deferral.¹⁵⁸ However the Courts did not approve. For example, in Estate of Roski v. Commissioner, 128 T.C. 113 (2007), the Tax Court held that the IRS could not make such a requirement and had to make the determination on a case by case basis.

¹⁵⁴ See Rev Rul 89-4, 1989-1 CB 298.

¹⁵⁵ See I.R.C. § 6166 (g)(2).

¹⁵⁶ See I.R.C. § 6166 (g)(3).

¹⁵⁷ See I.R.S. Notice 2007-90.

¹⁵⁸ See *id.*

Therefore, on November 13, 2007, the IRS issued Notice 2007-90 stating that they will determine whether they will require a bond or special lien on a case by case basis based on whether the estate poses a credit risk. Notice 2007-90 stated that regulations establishing factors that will be applied on a case by case basis will be forthcoming and listed the following factors that they will look at in the interim: duration and stability of the business; ability to pay the installments of tax and interest timely; and compliance history.¹⁵⁹

The Business Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association Task Force made the following recommendations: to amend Section 6324 to extend the term of the general estate tax lien with respect to estate tax deferrals under Section 6166;¹⁶⁰ to amend Section 6325 to provide more flexibility regarding release, subordination, and substitution of collateral for the estate tax liens; and to have a general policy to delay the bond requirement decision to secure deferred tax payment after expiration of the existing Section 6324 general lien.¹⁶¹

As of June 1, 2010, the Internal Revenue Manual at Sections 5.5.8.5, 4.25.1, and 4.25.2 give direction regarding the process for determining if a surety bond or special estate tax lien is required, lists factors that the IRS must look at, and gives the steps an estate must take to appeal such a requirement.¹⁶²

¹⁵⁹ See *id.*

¹⁶⁰ The Obama Budget Proposals for FY 2013 and again in FY 2014 have made a proposal to “extend the tax lien under §6324(a)(1) throughout the § 6166 deferral period”. DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS (2012), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf> and DEPARTMENT OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2014 REVENUE PROPOSALS (2013), available at <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>.

¹⁶¹ Memorandum from the Business Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association Task Force (Jan. 14, 2008) available at http://apps.americanbar.org/rppt/meetings_cle/2008/jointfall/Joint08/BusinessesAndBusinessPlanningGroup/CommentsToNotice2007-90.pdf.

¹⁶² Lisa M. Rico, Borrowing for Postmortem Liquidity, Part 2—A Primer on IRC § 6166, Probate & Property (Jan./Feb. 2011), <http://www.jdsupra.com/legalnews/borrowing-for-postmortem-liquidity-part-66944>.

In order to apply for the special lien Section 6324A requires a written agreement, signed by each person who has an interest in the designated property, consenting to the creation of the lien and designating a responsible person who shall be the agent for the beneficiaries of the estate and for the persons who have consented to the creation of the lien.¹⁶³ Section 6324A also provides that “the maximum value of the property which the Secretary may require as section 6166 lien property . . . [is] the sum of the deferred amount and the required interest amount”,¹⁶⁴ and that “if at any time the value of the property covered by the agreement is less than the unpaid portion of the deferred amount and the required interest amount, the Secretary may require the addition of property to the agreement (but he may not require under this paragraph that the value of the property covered by the agreement exceed such unpaid portion). If property having the required value is not added to the property covered by the agreement (or if other security equal to the required value is not furnished) within 90 days after notice and demand therefore by the Secretary, the failure to comply with the preceding sentence shall be treated as an act accelerating payment of the installments under section 6166(g)”.¹⁶⁵

There are several considerations that must be made before deciding to make a § 6166 election, including whether there is a possibility that the regular underpayment interest rates in § 6601(a) will increase.¹⁶⁶

e. **Graegin Loans**

Section 2053 and Treasury Regulation Section 20.2053 allow an estate to deduct interest expense from a loan taken to pay estate taxes as long as (1) the interest expense must be actually and necessarily incurred in the administration of the estate;¹⁶⁷ (2) the amount of the

¹⁶³ I.R.C. § 6324A(c).

¹⁶⁴ I.R.C. § 6324A(b)(2).

¹⁶⁵ I.R.C. § 6324A(d)(5).

¹⁶⁶ See Weinstock, *supra* note 32, at 411.

¹⁶⁷ Treas. Reg. § 20.2053-3(a).

estimated interest expense is ascertainable with reasonable certainty;¹⁶⁸ and (3) the expense will be paid.¹⁶⁹

Estate of Graegin v. Comm’r, 56 T.C.M. (CCH) 387 (T.C. 1988), is the seminal case allowing an upfront estate tax interest deduction for a fixed term loan where prepayment is prohibited (“Graegin Loan”). In Graegin the decedent’s estate was made up mostly of illiquid stock in a closely held business. Instead of selling the stock, the executor of the estate took out a fifteen year loan for \$204,218 that required payment of interest and principal at the end of the loan term and prohibited prepayment of the loan. The Tax Court held that the executor was allowed to deduct upfront the amount of interest that would be paid on maturity of the note because (1) the expense was necessary because the estate lacked liquidity, (2) the amount of the estimated interest expense was ascertainable with reasonable certainty because the amount could not be prepaid and could therefore be easily calculated, and (3) the interest on the loan would be repaid.¹⁷⁰

In three recent cases the Courts have not allowed an upfront estate tax interest deduction for the interest expense in Graegin Loans because the estate had enough liquid assets to cover the estate taxes,¹⁷¹ because the loan did not avoid having the illiquid assets sold¹⁷² and because the loan was not “necessary”¹⁷³. In particular, the Koons case involved an estate borrowing money to pay estate taxes from an LLC that it controlled. The Estate had no other significant assets except the LLC interest. The Court found the loan not “necessary” as the estate

¹⁶⁸ Treas. Reg. § 20.2053-3(d)(4).

¹⁶⁹ See id.

¹⁷⁰ “In deciding that the loan was in fact *bona fide* [and would be repaid], the court noted the reasonableness of the loan terms, the approval of the loan arrangement by the probate court, and the presence of some non identity of interest due to the fact that the closely held business included an unrelated shareholder who would likely complain if interest payments were not made on the loan”. Planning Ideas-The Graegin Note Revisited, CANNON INSIGHTS, July, 2010 available at <http://www.cannonfinancial.com/resources/newsletter/CI-Planningtwo1110.pdf>.

¹⁷¹ Estate of Stick v. Comm’r, 100 T.C.M. (CCH) 194 (T.C. 2010).

¹⁷² Estate of Black v. Comm’r, 133 T.C. 340 (2009)

¹⁷³ Estate of Koons, 105 T.C.M (CCH) 1567 (2013)

had the ability to force the LLC to make a cash distribution to it. Further, the loan was most likely to be repaid when it became due (18 years later) by cash the estate obtained from a distribution from an LLC, as there was no other source of cash. The Court looked negatively on the loan as it did not prevent any illiquid assets from having to be sold at a forced sale. However, the interest for Graegin Loans can still be deducted as long as all of the Section 2053 requirements are met and the estate can prove the loan is necessary to prevent a fire sale and there are no other viable liquidity options, as evidenced in the majority of the recent cases, which have followed the reasoning set forth in Graegin.¹⁷⁴

ESTATE PLANNING FOR FOREIGN INVESTORS IN U.S. REAL ESTATE

Estate planning for the foreign investor in U.S. real estate may be considerably more complicated. Domestic and foreign income tax consequences must be factored into the equation. In addition, since the U.S. tax system may not dovetail with that of the investor's home country, care must be exercised to avoid double taxation. However, it is frequently possible to significantly reduce the income and estate tax burdens for the foreign investor. The below discussion is merely an introduction to this complex area.

A. There are various ways in which to structure a foreign investment in U.S. real estate the five most common are (1) without an intervening corporation, (2) through a single U.S. corporation, (3) through a foreign corporation, (4) through a combination of a U.S. and foreign corporation, or (5) through a private real estate investment trust (REIT).

1. **Ownership without an intervening corporation** – this is the most cost efficient form from a pure income tax standpoint but is relatively

¹⁷⁴ See Estate of Duncan v. Comm'r, 102 T.C.M. (CCH) 421 (T.C. 2011) (holding that the executor could deduct the loan interest even where the lender and borrower trusts had the same trustees and beneficiaries); See also Estate of Murphy v. United States, 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); See also Keller v. United States, CIV.A. V-02-62, 2009 WL 2601611 (S.D. Tex. Aug. 20, 2009).

uncommon due to the disadvantages.¹⁷⁵ With this type of formation the foreign investor owns the real estate directly without a corporation. Under this structure if the activity rises to the level of a U.S. trade or business, under the current rental income (the net income after deductions for expenses) will be taxed under Section 871(b) at the federal level at a rate of 35%.¹⁷⁶ There may be additional state and local taxes imposed as well.

i. Advantages

1. Low U.S. federal capital gains rate (15%) on sale of the real estate – the rate could be 25% to the extent of prior depreciation.¹⁷⁷
2. The ability to repatriate funds without incurring a second level of tax.¹⁷⁸

ii. Disadvantages

1. The real estate is subject to U.S. estate tax on the death of the foreign individual.¹⁷⁹

¹⁷⁵ Jack Mandel & Alan I. Appel, Tax Structuring of Foreign Investment in U.S. Real Estate, Various Structures to Limit the U.S. Tax Exposure, Institutional Investment Real Estate Magazine, (2009). Available at <http://www.bryancave.com/files/News/59b80ea0-b3ed-47e3-a60e-d31813d97347/Presentation/NewsAttachment/f6da66e8-ea16-4245-89c5-d465715c5b3c/MandelAppelArticlepdf.pdf>

¹⁷⁶ Although the term “trade or business within the United States” is not defined in the Code a trade or business will be found to exist if there are regular, continuous and considerable business activities. See, *De Amodio v. Commissioner*, 34 T.C. 894, 905-06 (1960), aff’d, 299 F.2d 623 (3rd Cir. 1962) (concluding that the taxpayer had engaged in a U.S. business because the activities of the taxpayer’s agent were considerable, continuous and regular, and that those activities which constituted more than the mere ownership of real property or receipt of income from real property, were attributable to the taxpayer).

¹⁷⁷ Jack Mandel & Alan I. Appel, Tax Structuring of Foreign Investment in U.S. Real Estate, Various Structures to Limit the U.S. Tax Exposure, Institutional Investment Real Estate Magazine, (2009). Available at <http://www.bryancave.com/files/News/59b80ea0-b3ed-47e3-a60ed31813d97347/Presentation/NewsAttachment/f6da66e8-ea16-4245-89c5-d465715c5b3c/MandelAppelArticlepdf.pdf>

¹⁷⁸ Id.

¹⁷⁹ Id.

2. A lack of unanimity since the individual is obligated to file U.S. income tax returns with respect to the property.¹⁸⁰

a. This is also an administrative burden.

2. **Single-tier U.S. corporate ownerships** – this is generally not advisable because although corporate level tax rates on current income are similar to those under an individual ownership structure, there can be higher taxes on sale and repatriation of funds.¹⁸¹

i. The distributions by the U.S. corporation will be subject, under Section 1441, to a 30% withholding tax (subject to reduction by treaties) to the extent of earnings and profits and a U.S. shareholder level FIRPTA¹⁸² tax to the extent distributions exceed earnings and profits.¹⁸³

ii. If there are no assets in the corporation other than sale proceeds, the corporation can generally be liquidated and the proceeds repatriated free of a second level of tax.¹⁸⁴

1. Thus, subject to certain restrictions, it may be possible for the corporation to retain earnings until the property is sold and avoid a second level of tax on the repatriation of funds.

¹⁸⁰ Id.

¹⁸¹ Id.

¹⁸² See, the Foreign Investment in U.S. Real Property Tax Act of 1980 (FIRPTA), Pub. L. No. 96-499, 94 Stat. 2599, 2682 (Dec. 5, 1980).

¹⁸³ Jack Mandel & Alan I. Appel, *supra* note 3.

¹⁸⁴ Id.

iii. Disadvantages

1. This form does not shield against the U.S. estate tax being imposed on the death of the shareholder.
2. There is limited anonymity because the U.S. corporation's tax return requires the disclosure of the name, address, and taxpayer identification number of any person owning 50% or more of the stock of the corporation.

3. **Ownership through a foreign corporation alone**

i. Disadvantages

1. Although the basic U.S. federal tax rates on operating income will be similar to the non-corporate and U.S. corporate ownership, the foreign corporation will be subject to an additional "branch profits tax" of 30% (subject to reduction by treaty) on, in general, its annual earnings and profits.¹⁸⁵
 - a. The effective federal tax rate would be approximately 56.5% after taking account of the deductibility of the basic income tax when computing the branch profits tax.¹⁸⁶
2. Gain recognized on the sale of the real estate is taxed at the same rates as current income

¹⁸⁵ I.R.C. § 884

¹⁸⁶ Jack Mandel & Alan I. Appel, *supra* note 3.

3. Although the sale of the stock of the foreign corporation should be free of U.S. federal income tax the buyer will likely demand a significant discount in the price for taking over the inherent tax liabilities.¹⁸⁷
4. Although there is no dividend withholding tax repatriation may be a factor in computing the branch profits tax.¹⁸⁸

ii. Advantages

1. The stock of the foreign corporation is generally thought not to be subject to U.S. estate tax on the death of the individual.¹⁸⁹
 2. Similar to the single level U.S. corporate structure, this structure provides limited anonymity because the tax return requires the disclosure of the name, address, and taxpayer identification number of any person owning 50% or more of the stock in the corporation.
 - a. Note that a second foreign corporation could be interposed if greater anonymity is desired.
4. **Foreign and U.S. corporation combination structure** – this is the most common structure under which a foreign corporation is established whose sole asset is all of the stock of a U.S. corporation, which, in turn, acquires

¹⁸⁷ Id.

¹⁸⁸ Id.

¹⁸⁹ Id.

the real estate investment.¹⁹⁰ Although this two-tiered structure is more intricate than others its advantages make it useful despite the complexity.

i. Advantages

1. The complex branch profits tax will not be applicable since the operating asset (the real estate investment) and income generated from the asset reside in the U.S. corporation.¹⁹¹
2. Anonymity can be preserved because although the U.S. corporation must disclose the identity of its 100% shareholder by name, only the identity of the corporation will be disclosed.
 - a. The foreign corporation is under no obligation to disclose its shareholder since it is not engaged in a U.S. trade or business.
3. Assuming no operating income is to be distributed out of the U.S., once the property is sold by the U.S. corporation in a fully taxable transaction and one level of U.S. tax has been paid on the gain, the U.S. corporation can be liquidated. The cash as a result of the liquidation can be distributed to the foreign corporation free of any U.S. withholding tax. The foreign corporation is then free to

¹⁹⁰ Id.

¹⁹¹ Id.

distribute the cash to the ultimate shareholder free of an U.S. tax impact.¹⁹²

a. In addition the stock of the foreign corporation could be sold free of U.S. federal income tax although the buyer will likely demand a discount in the price for taking over the inherent tax liabilities.

4. The conventional wisdom is that neither U.S. estate nor gift tax will apply to a lifetime gift or testamentary transfer of the stock in the foreign corporation.¹⁹³

ii. Disadvantage

1. Under the structure of holding the real estate in a foreign corporation it is more likely that it will be possible to distribute refinance proceeds free of U.S. tax, however the same is not true under the foreign and U.S. corporation combination structure.¹⁹⁴

5. **“Domestically-controlled” REIT** – although distributions from private REITs to non-U.S. investors are normally subject to FIRPTA tax there is an exception for “domestically-controlled” REITs.¹⁹⁵ The REIT must be structured in a way to demonstrate domestic control – U.S. investors must

¹⁹² Id.

¹⁹³ Id.

¹⁹⁴ Jack Mandel & Alan I. Appel, *supra* note 3.

¹⁹⁵ White & Case, U.S. Real Estate Funds and “FIRPTA” Structures to Maximize Net Returns to Non-U.S. Investors, (Summer 2010).

hold more than 50% of the capital of the REIT and non-U.S. investors cannot otherwise exercise control over the REIT.¹⁹⁶

i. Advantage

1. Domestically controlled REITs are not considered to be U.S. Real Property Interests (USRPIs) under FRIPTA, therefore foreign investors are not subject to tax under FIRPTA upon the sale of their shares in a REIT.¹⁹⁷

ii. Disadvantage

1. Dividend distributions made by a REIT to a foreign investor attributable to gains from sales or exchanges under a REIT are considered USRPIs and subject to U.S. tax under FIRPTA.¹⁹⁸

SPECIAL INCOME TAX CONSIDERATIONS FOR LEVERAGED ESTATE HOLDINGS

Historically, our tax and economic system have encouraged the use of leverage to finance expansion and growth in the real estate sector of the economy. The ability to cash out through refinancing without paying tax on the proceeds (at least at the time of the refinancing) and to finance improvements with indebtedness, which can result in depreciation deductions attributable to borrowed funds, have made leveraging a tax favored method of financing a real estate portfolio. The favorable treatment of leverage results in a deferral of the incidents of taxation – not an elimination. However, when assets are held until death, the deferral becomes permanent due to the basis step up allowed by section 1014 of the Code.

¹⁹⁶ Id.

¹⁹⁷ Deloitte, Introduction to the Taxation of Foreign Investment in U.S. Real Estate, (February 2010).

¹⁹⁸ Id.

Estate planning for leveraged real estate requires special planning to continue the deferral until death. It is inherent in such planning that appreciation and growth must be shifted to succeeding generations. In general, when inter vivos gifts are made there is no basis step up. At the most fundamental level, there is a trade off between retaining assets until death to obtain the basis step up, on the one hand, and transferring assets during lifetime before they appreciate but without the basis step up. For gifting transactions, there is generally, a carryover basis under section 1015 of the Code.

The delicate balance when planning for leveraged real estate is to achieve the basis step up on the deferred gain inherent in these assets while transferring the appreciation during lifetime. This type of planning is particularly challenging insofar as the income tax and the estate tax rules do not always interact harmoniously – particularly where there is “negative capital”.

Dealing with negative capital or liabilities in excess of basis puts a greater emphasis on the income tax side of planning. Popular estate planning techniques, such as grantor retained annuity trusts (GRATs), installment sales to defective grantor trusts (IDITS), and outright gifts, may not work well for these assets since they can trigger unexpected income tax liabilities. These tax liabilities can be completely avoided if the asset is held until death due to the basis step up under section 1014 of the Internal Revenue Code (the “Code”). This can serve as a major disincentive and impediment to estate and transfer tax planning.

This scenario is relatively common for real estate interests where cash proceeds of refinancing have been taken or where the property has been fully depreciated. Worse yet, the triggering of this gain can often result in an income tax liability to the transferor that is greater than the potential estate tax savings, or, perhaps, the equity values that were the initial motivation for the creation of the GRATs, IDITS, etc.

The tax impact of negative capital can be illustrated as follows:

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)
Capital	
Equity (cash proceeds from a sale)	\$ 2,000,000
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	
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<small>12</small>	

1. Public Holdings REITs, UPREITs, and Estate Planning

a. REITs Generally

Long term successful real estate owners may seek to raise funds for expansion in the capital markets by formation of a real estate investment trust (“REIT”).

The Internal Revenue Code Sections 856 through 859 lay out the intricate organizational framework for a REIT. There are eight organizational requirements an entity must meet to be a REIT. The entity: (1) must be a corporation, trust, or association; (2) must not be an insurance company or financial institution; (3) must be taxable as a domestic corporation if it were not a REIT; (4) must elect to be taxed as a REIT; (5) must have centralized management by trustees or directors (6) must have at least 100 persons; (7) must own transferable shares or

certificates; and (8) does not have six individuals owning more than 50 percent of the value of the equity.¹⁹⁹

b. UPREITs Generally – Used to avoid gain recognition on negative capital

There are certain income tax challenges to the formation of a REIT when the holdings are subject to liabilities in excess of basis. The liabilities in excess of basis can result in gain recognition upon the contribution of leveraged real estate to a REIT, typically a corporation, under section 357(c) of the Code. The frequent objective is to take advantage of the access of the REIT to the capital markets while continuing the deferral of gain on negative capital – perhaps until death. If the negative capital can be preserved, the estate planning for these assets is similar as that for other leveraged real estate with negative capital.

Certain transactional structures have been developed to allow deferral of the gain inherent in the negative capital. An example is the combination of a traditional REIT and a limited partnership, often referred to as the operating partnership (OP), which creates an UPREIT. In contrast to a traditional REIT, which invests in real estate assets directly, with an UPREIT the real estate assets are held by the OP, and the REIT conducts most of its operations through the OP as the OP’s general partner.²⁰⁰

The structure of the UPREIT was created to accommodate real estate holders with “built-in gain” attributable to liabilities in excess of basis that would otherwise require gain recognition upon contribution of the property subject to the liabilities in excess of basis in connection with a normal corporate formation transaction governed by section 351. Section 351(a) of the Internal Revenue Code provides that, “no gain or loss shall be recognized if

¹⁹⁹ Brian K. Jordan, Real Property, Probate and Trust Law: Ups and Downs: A REIT Dilemma, 73 Fla. Bar J. 54 (July/Aug 1999).

²⁰⁰ Bart Sheehan & Marshall D. Feiring, Background and Development of the REIT Industry, Practising Law Institute, Financial Product Fundamentals, (July, 12 2012).

property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.²⁰¹ This rule however does not apply in the case of property transferred to an investment company.²⁰² A transfer is considered made to an investment company if: it results in a diversification of the transferor's interests and the transferee is or intends to become a REIT²⁰³ For purposes of Treas. Reg. Section 1.351-1(c)(5) the contribution of cash in exchange for REIT shares and the contribution of appreciated property in exchange for other REIT shares is treated as a diversification of interests.²⁰⁴

As a result, if an existing owner contributes appreciated property to a REIT in exchange for REIT shares, even if the transaction is part of a public offering, it will be fully taxable to the existing owner.²⁰⁵

c. **Formation of an UPREIT**

Under the UPREIT structure an “umbrella” or “operating” partnership is formed to hold the real property to be securitized.²⁰⁶ The umbrella partnership is formed by having the existing owners contribute their interests in the appreciated real property to the partnership in exchange for limited partnership interests.²⁰⁷ If the real property is currently held by a property partnership then either: all or a portion of the existing-owner partners may contribute their property partnership interests to the umbrella or the property partnership itself may contribute its properties in exchange for the umbrella partnership units and then liquidate.²⁰⁸

²⁰¹ I.R.C. § 351(a)

²⁰² I.R.C. § 351(e)(1)

²⁰³ Treas. Reg. § 1.351-1(c)(1)-(2).

²⁰⁴ Rev. Rul. 87-9, 1987-1 C.B. 133 (cash was treated as diversifying asset).

²⁰⁵ Gregory W. Goff & Iman Anabtawi, Umbrella Partnership REITs (UPREITs), 46-21 USC Law School Institutes On Major Tax Planning, 2105.

²⁰⁶ Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).

²⁰⁷ Gregory W. Goff & Iman Anabtawi, Umbrella Partnership REITs (UPREITs), 46-21 USC Law School Institutes On Major Tax Planning, 2105.

²⁰⁸ Id.

Simultaneously with the contribution, the newly formed REIT will raise cash from a public offering of shares. This capital is then contributed to the umbrella partnership in exchange for the general partnership interest in the umbrella partnership.²⁰⁹ The umbrella partnership then uses the capital contribution by the REIT to either: repay debt carried on the properties contributed by the existing owners or to fund new acquisitions.²¹⁰

Following the formation transactions of the UPREIT the existing owners receive pro rata distributions from the umbrella partnership on their limited partnership interests. Distributions are also passed through to the UPREIT's public shareholders.²¹¹

In addition to partnership interests, the umbrella partnership's agreement generally provides that limited partners may exchange their partnership interests for shares in the UPREIT on a one-to-one basis, or, at the UPREIT's election, an equivalent amount of cash.²¹² Although this future conversion of umbrella partnership interest to UPREIT shares will be a taxable event, the original partner has the ability to time the exchange thus allowing for efficient tax planning and liquidity.

From an estate planning perspective UPREITS are a tremendous tool. Under section 1014 a post-death conversion of partnership interest to UPREIT shares or cash allows survivors to receive a "stepped up" basis in the partnership interest without incurring tax liability other than appreciation going forward.²¹³ As will be explained below, like other long term holders of leveraged investment real estate, the holder of UPREIT shares will benefit from the special estate planning techniques described below – namely, the use of the entity freeze under section 2701 of the Code.

²⁰⁹ Id.

²¹⁰ Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).

²¹¹ Id.

²¹² Bart Sheehan & Marshall D. Feiring, Background and Development of the REIT Industry, Practising Law Institute, Financial Product Fundamentals, (July, 12 2012).

²¹³ Id.

d. Deferral of Taxable Gain

The original owner's of the appreciated property's tax recognition is deferred until the partnership either sells the property in a taxable transaction or when the owner converts his partnership interest to REIT shares or cash. In order to maintain control over tax deferral the property owner usually negotiates a standstill agreement where the REIT agrees not to sell the property in a taxable disposition for a certain period of time, usually five to ten years.²¹⁴ In order to further maintain control of the property owner and REIT may agree to a lesser remediation such as a best efforts attempt to facilitate an exchange under § 1031 rather than a sale, or the property owner may obtain a right of first refusal to repurchase the property.²¹⁵

e. Drawbacks of the UPREIT Structure

Although the UPREIT structure has been used to circumvent adverse tax consequences for holders of appreciated real property it is not without fault. The structure presents the possibility for conflict between the UPREIT's public shareholders and the holders of the partnership units; such conflicts arise in four situations: (1) paying down debt on contributed properties, (2) the potential sale of contributed properties, (3) the choice of depreciation allocation methods with respect to contributed property with built-in gain under section 704(c) and (4) a potential merger or acquisition situations, particularly involving cash offers.²¹⁶ Under each of the above situations a conflict arises where: the holders of the partnership units wish to continue to defer tax liabilities on the contributed properties and their tax basis, and the UPREIT shareholders, who do not share such concerns, seek only to maximize the return on their investment in the UPREIT.²¹⁷

²¹⁴ James P. deBree, Jr. UPREITs and DownREITs Gain Popularity, Commercial Investment Real Estate Magazine, (Mar/April 1998). <http://www.ccim.com/cire-magazine/articles/upreits-and-downreits-gain-popularity>

²¹⁵ Id.

²¹⁶ Clifford E. Kirsch, UPREITs, §14:3.1 (Nov. 2011).

²¹⁷ Id.

PLANNING FOR NEGATIVE CAPITAL - USE OF GRANTOR TRUSTS

Both GRATS and IDGTS are, if correctly drafted, known as grantor trusts within the meaning of Section 671. The consequences of being a grantor trust is that income earned by the GRAT or IDGT is deemed to be earned by the grantor, and thus taxed to the grantor. For income tax purposes no sale is deemed to occur as long as the trust remains a grantor trust. Rev. Ruling 85-13, 1985-1 C.B. 184.

The income tax paid by the grantor for the GRAT's/IDGT's income is, in effect, a further nontaxable gift. In addition, a transfer to a GRAT or IDGT is essentially ignored for income tax purposes. These characteristics generally enhance the tax benefits and estate planning objectives of the grantor. For instance, in general, a sale, even of leveraged real estate, to a GRAT or IDGT does not trigger a taxable gain to the grantor. Similarly, a gift of property subject to liabilities in excess of basis (or a partnership interest with a negative capital account) to a GRAT or IDGT is not a taxable event to the grantor, at least initially.

Contrast this with an outright gift of property with liabilities in excess of basis that will, at a minimum, be treated as a taxable sale of the property for the amount of the liabilities. The problem with this non-recognition-of-gain tax treatment is that the taxable event avoided when the GRAT or IDGT was created may be triggered later on the termination of the grantor trust status of the trust. With a GRAT, this occurs on the expiration of the GRAT's term unless there is a continuing trust that is a grantor trust. For an IDGT, termination occurs on the grantor's death or perhaps sooner.

The GRAT or IDGT transactions may forego a stepped-up basis on death. The stepped-up basis can extinguish the phantom income tax liability potential inherent in such leveraged real estate interests forever. This lack of a basis step-up is true for all lifetime gifts, and not getting it can be a reasonable tradeoff for saving estate taxes in some situations. In the

context of leveraged real estate with liabilities in excess of basis, however, the loss of a stepped-up basis can be fatal to an otherwise sensible plan.

a. **Income Tax Challenges of GRATs and IDGTs**

With the GRAT or the IDGT, the transfer is essentially ignored for income tax purposes.²¹⁸ Consequently, if there were a transfer that would otherwise generate income tax consequences, those consequences are avoided (or perhaps better stated, deferred) at inception. For example, a sale of appreciated property for an annuity may generate taxable gain unless the purchaser is a grantor trust as to the seller. Likewise, a sale of an appreciated asset to a trust would, absent the grantor trust rules, result in gain recognition. Contrast an outright gift to a trust that would not normally result in a taxable gain. Yet outright gifts are not usually considered optimal since they do not entail leverage. GRATs and IDGTs do involve leverage so that more appreciation may be transferred if the asset appreciates after the transfer. Lifetime gift exemptions, and other gift exemptions, can be significantly leveraged through these techniques contrasted with the outright gift.

Even an outright gift can trigger income tax consequences if the transferred asset is subject to liabilities in excess of basis. Nonetheless, if the transfer is made to a grantor trust, the income tax consequences can likewise be avoided, at least at inception.

The problem with transfers to grantor trusts is that if the trust ceases to be a grantor trust, the tax consequences that were avoided at inception may be triggered. The following paragraphs discuss when and if these tax consequences may be incurred.

As discussed above, both GRATs and IDGTs are, if correctly drafted, grantor trusts within the meaning of section 671. As a consequence of being a grantor trust, income earned by the GRAT or IDGT is deemed to be earned by the grantor and thus taxed to the

²¹⁸ See *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984) and Rev. Rul. 85-13.

grantor. When the grantor sells assets to the grantor trust (or when assets are deemed sold where liabilities exceed basis) the grantor is treated as having retained ownership of the asset so that as long as the trust remains a grantor trust no sale is deemed to occur for income tax purposes.²¹⁹ Also note that while the grantor is treated as having retained ownership of the assets, the transfer can be deemed completed for gift, estate and generation skipping taxes purposes.

The corollary to this non-recognition-of-gain tax treatment is that the taxable event avoided at the time of transfer may be triggered later on the termination of grantor trust status. For a GRAT, this occurs on the expiration of the GRAT term if the grantor survives the term. For an IDGT, termination occurs on the grantor's death, or perhaps sooner if grantor trust status is otherwise terminated.²²⁰ As discussed below, there is some disagreement among commentators as to whether gain is triggered, or if a basis step-up is obtained, upon the death of the grantor.

Normally, when a gift is made there is no basis step-up under section 1015. Section 1015 provides that a donee's basis in gifted assets is the lesser of the assets' fair market value or the donor's basis in the assets. The lack of a basis step-up can be a reasonable tradeoff for saving transfer taxes in the long run. Yet where liabilities exceed basis, the loss of the step-up can significantly reduce the benefits of such planning. It is debatable whether it is even possible to transfer assets that are so encumbered to a succeeding generation without triggering gain on liabilities in excess of basis. In the context of leveraged real estate with liabilities in excess of basis, the loss of a stepped-up basis can be fatal to an otherwise sensible plan.

²¹⁹ Rev. Rul. 85-13.

²²⁰ Some of the key features that would cause a trust to be a grantor trust include: (i) grantor or a nonadverse party having a power to direct the beneficial enjoyment of the trust income or principal without the approval or consent of any adverse party, (ii) grantor, in a non-fiduciary capacity, having the power to reacquire trust property, by substituting property of equivalent value without the approval or consent of any person in a fiduciary capacity, and (iii) grantor having the power to revest title to trust property. *See* IRC §§ 671-679.

The use of GRAT or IDGT transactions may preclude the basis step-up that would otherwise occur upon the death of the grantor, which step-up would eliminate the phantom income attributable to liabilities in excess of basis or negative capital. This can be a major disadvantage when planning involves leveraged low basis real estate or interests in partnerships holding such assets.

b. Uncertain Tax Consequences of the Grantor Trust - Death of the Grantor

The income tax treatment of a grantor trust upon the death of the grantor is a matter of some debate among the commentators. In order to comprehend the debate, it is necessary to summarize the basics.

As mentioned above, termination of grantor trust status during the grantor's lifetime will trigger gain if the grantor trust assets are subject to liabilities in excess of basis.²²¹ The law is not 100% clear on whether or not the death of the grantor should likewise be deemed a sale triggering gain. The IRS has recently noted that the death of the grantor generally does not cause income recognition.²²² Some commentators have asserted in their writings that termination of grantor trust status as a result of the death of the grantor should have a similar result to a testamentary transfer.²²³ These commentators reason, in essence, that the retained interest for income tax purposes is sufficient to deem the termination of grantor trust status by

²²¹ See Treas. Reg. § 1.1001-2(c), Ex. 5 (providing grantor recognizes gain upon termination of grantor trust status equal to the excess of his relief from partnership debt over the basis in his partnership interest). See also *Madorin v. Comm'r*, 84 T.C. 667 (1985) (upholding Ex. 5 in Treas. Reg. § 1.1001-2(c) on similar facts where the grantor realizes gain from debt relief on disposition of trust assets at the moment when grantor trust status ceases and trusts became separate taxable entities); Rev. Rul. 77-402, 1977-2 C.B. 222 (ruling grantor recognizes gain on cessation of grantor trust status as a taxable disposition of partnership interest measured by the difference between the basis in the partnership and his share of partnership liabilities).

²²² 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").

²²³ See generally Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n. 149 (2002). See also *Crane v. Comm'r*, 331 U.S. 1 (1947)(many commentators believe *Crane* is the basis for the "no gain on death" rule).

reason of the grantor's death to be a testamentary transfer.²²⁴ However, other commentators do not agree. According to these other commentators, the death of the grantor will trigger a taxable gain where the initial sale was not recognized as a result of grantor trust status.²²⁵

The related question is whether death of the grantor would give rise to a basis step-up under section 1014. The language of section 1014 implies that a condition of the trust's basis step-up upon the death of a grantor is that the grantor generally must have the types of rights over the trust property that would result in inclusion in the grantor's gross estate for estate tax purposes. The implication is that the termination of grantor trust status by reason of the grantor's death should not be viewed as a testamentary transfer unless the grantor retained the type of rights that would result in estate tax inclusion.²²⁶ The IRS has made it clear that its position would be that section 1014 does not apply in this situation because section 1014 requires that the asset in question be included in the decedent's estate for estate tax purposes.²²⁷

Some commentators believe that even if section 1014 is not applicable to the termination of grantor trust status by reason of death where there is no estate tax inclusion, section 1012 should apply a basis step-up since the recipient of the property assumes or takes subject to the debt. This theory is often referred to as the *Crane* doctrine since it is derived from

²²⁴ See Treas. Reg. § 1.1001-2(c) Example 5 (adopting tax fiction that the grantor owns a partnership interest that, in fact, is owned for all non-income tax purposes by the trust, and, based on this fiction, subject the grantor to the Subchapter-K income tax rules that apply only to taxpayers who actually own a partnership interest). See also *Estate of DiMarco v. Comm'r*, 87 T.C. 653 (1986) (treating the grantor of a lifetime trust as having made a testamentary transfer for tax purposes even though it clearly would have been viewed as lifetime in character for all other purposes).

²²⁵ See generally Carol A. Cantrell, *Gain Is Realized at Death*, Trusts & Estates, (Feb. 2010); Deborah D. Dunn and David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. Tax'n. 49 (2001). See also IRC § 684 (codifying that losing grantor trust status on foreign grantor trust results in recognition of gain). Treasury Regulations extend the rule of foreign grantor trusts to domestic grantor trusts. Treas. Reg. § 1.684-2(e)(2), Ex. 2. These commentators argue that death of the grantor of a domestic grantor trust should have the same result as a foreign grantor trust. See Rev. Rul. 77-402, 1977-2 C.B. 222 (holding that gain is recognized where a trust ceases to be a grantor trust by reason of expiration or lapse of powers).

²²⁶ See Treas. Reg. § 1.1014-2(a)(1) (stating that there will be a basis step-up on property acquired from a decedent only if the property is included in the decedent's gross estate for estate tax purposes).

²²⁷ See CCA 200937028.

the 1947 United States Supreme Court decision in Crane v. Comm'r²²⁸. In *Crane*, the beneficiary inherited an asset that was encumbered by a liability exactly equal to its fair market value. The government argued that since there was no equity in the property, the recipient should not acquire a basis step-up. The court was faced with the dilemma as to whether it is necessary for there to be “equity” in the property for it to be considered to have been acquired from the decedent by inheritance (which would result in a basis step-up under a predecessor to section 1014. The Court found that it is not necessary for there to have been “equity” in the property. The Court also noted that a basis step-up should be allowed since the property was transferred subject to nonrecourse debt. The court analogized to the acquisition of property by purchase subject to nonrecourse debt. In that situation, the recipient would be entitled to a cost basis that includes the indebtedness to which the property is subject. The court applied similar principles to the acquisition of property by inheritance subject to nonrecourse indebtedness so long as the property is worth more than the debt.²²⁹ The Court could have treated the transfer as a sale and given the legatee a cost basis for the purchase under the predecessor of section 1012. Instead, the Court treated the transfer as a devise and therefore basis was determined under the predecessor to section 1014 which provides that basis is equal to asset’s estate tax value (fair market value).²³⁰

²²⁸ 331 U.S. 1 (1947)

²²⁹ *Id.* at n. 37 (finding “Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case”); *see also id.* at n. 42 (stating “In the course of the argument some reference was made, as by analogy, to a situation in which a taxpayer acquired by devise property subject to a mortgage in an amount greater than the then value of the property, and later transferred it to a third person, still subject to the mortgage, and for a cash boot. Whether or not the difference between the value of the property on acquisition and the amount of the mortgage would in that situation constitute either statutory or constitutional income is a question which is different from the one before us, and which we need not presently answer”).

²³⁰ There is an exception to the *Crane* doctrine for liability encumbered gifts made during donor’s lifetime. *Diedrich v. Comm’r*, 457 U.S. 191 (1982). In *Diedrich*, the Court qualified the rule by creating an exception for liability encumbered gifts. *See also Ebben v. Comm’r*, 783 F.2d 906 57 (9th Cir. 1986) (holding, without citing *Diedrich*, that a gift to a charity of property encumbered by a liability should be treated as a sale for the purpose of section 1011(b)). However, many commentators argue that this exception has never been applied to testamentary gifts and

Note that the central issue in *Crane* was not whether there would be gain upon death where the property is subject to liabilities in excess of basis. Nevertheless, the conclusion in *Crane* certainly implies that would be the rule. This implication is the basis for the widely recognized no gain upon death or Crane doctrine.

Applied in the context of a grantor trust, commentators stack the principles of Revenue Ruling 85-13, which delays the recognition of gain on a sale to a grantor trust until the grantor trust status is terminated, with the Crane doctrine to conclude that there should be no gain recognition upon the termination of grantor trust status by reason of the death of the grantor.²³¹

In the context of an installment sale to a grantor trust, commentators suggest that there may be gain recognition of the unpaid installment notes upon the death or the grantor or other termination of grantor trust status.²³² Even if gain is not recognized at the time of death²³³, gain recognized after death is income in respect of a decedent (“IRD”) when the note is paid.²³⁴ Under such installment sale reporting, the successor in interest reports the deferred gain as installment payments are made. This result occurs because under Revenue Rule 85-13 the original installment sale to the grantor trust was not deemed a sale for federal income tax purposes and thus the decedent did not report income under the installment method during his lifetime. Thus, payments subsequent to the decedent’s death constitute gain.

it makes sense to distinguish between them. In the absence of the exception, a taxpayer could borrow against an asset up to its value and then make a gift of the asset subject to the liability without recognizing gain, in effect converting the asset to cash on a tax-free basis. Such a concern does not apply to testamentary gifts because taxpayers seeking to enjoy the benefit of the no-gain-at-death rule must die first in order to come within its scope.

²³¹ See Blattmachr, note 17; *but see* Cantrell, note 19 (arguing that it is inappropriate to suggest that *Crane* is indicative of a general no-gain-on-death rule since *Crane* is about a testamentary transfer and not a deemed transfer of ownership which only existed with respect to income tax purposes).

²³² See, e.g., Carol A. Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, for ALI-ABA Planning Techniques for Large Estates, May 16-20, 2011 (November 2010).

²³³ See IRC § 453B(c).

²³⁴ IRC § 691; Treas. Reg. § 1.451-1(b)(2).

c. Contrast Entity Freezes

On the other hand, the entity freeze under section 2701, if properly structured, can avoid the tax consequences associated with transfers to grantor trusts, whether those consequences are incurred at inception or at the termination of trust's grantor trust status. The entity freeze technique normally does not depend upon a transfer to a grantor trust to avoid the income tax consequences of its creation. For example, if the entity freeze involves a partnership, or limited liability company taxed as a partnership, the initial transfer would normally be treated as a contribution to a partnership rather than a transfer to a grantor trust. The rules governing contributions of appreciated property to partnerships are very different from the grantor trust rules. Contributions to partnerships in exchange for partnership interests are normally entitled to no recognition under section 721. Even if the property is subject to liabilities in excess of basis, in general, gain will not be recognized at inception under the interplay between section 704(c) and section 752, both of which are discussed in greater detail below.

d. Game Changing Proposals for Grantor Trusts

The Obama Administration's proposals to eliminate the current favorable treatment of grantor trusts may, if enacted, put an end to much of estate planning as we know it for the wealthier client who owns a business or actively managed real estate. These types of assets are typically illiquid. Moreover, these clients may have estates that are too large to plan for with straightforward annual exclusion gifts or even gifts of the current lifetime exemption of \$5,250,000.

To plan for these clients, it is necessary to leverage the exemptions. Most leveraging transactions (such as installment sales to intentionally defective grantor trusts and grantor retained annuity trusts) depend in large part on the ability to transfer assets to a grantor trust without incurring an income tax at the time of such transfer.

The Obama Administration's revenue proposals for fiscal year 2014 (a repeat of the proposal from FY 2013) contain radical changes to the treatment of grantor trusts which would, in effect, impose an income tax on appreciated assets transferred in these leveraged estate planning transactions. This change would be effected by providing that transfers to grantor trusts are incompleting gifts. Thus, in order to leverage exemptions and transfer appreciating assets out of the estate, it would be necessary for transactions to be done with nongrantor trusts. Thus, either there would be a taxable gift or income tax recognition in connection with these transfers. Since either a gift tax or an income tax would be required to be paid currently, these transactions would be much less effective in shifting wealth and appreciation. Clients would be much less willing to engage in such transactions if they are subject to current income taxation – even if significant long term transfer tax savings may still be achieved. The current state of the law does provide some ability to mitigate transfer taxes imposed on succession planning for these business or real estate interests.

According to the green book, the proposals are only applicable to trusts that engage in transactions after the date of the enactment. Therefore, it is possible that trusts created prior to the date of enactment will not be precluded from engaging in gift tax complete sales with the grantor subsequent to the enactment – as long as the sale does not also involve an additional gift. Nevertheless, there is a broad grant of regulatory authority that may provide a basis to curtail this apparent grandfathering of existing trusts. It does appear that transactions completed prior to enactment date will continue to be governed under current (pre-amendment) law.

One planning technique that will be minimally impacted by any such change would be the entity freeze under IRC section 2701. Freezes using partnerships or limited

liability companies can be structured to avoid some of the income tax pitfalls of transactions with grantor trusts.”²³⁵

FREEZE PARTNERSHIPS FOR LEVERAGED LOW BASIS REAL ESTATE INVESTMENTS

The partnership entity freeze (or “partnership freeze”) is the preferred method of planning when the client owns low basis leveraged real estate. Failure to appropriately plan for the inherent income tax consequences of property with liabilities in excess of basis can have devastating tax consequences.

As discussed above, this type of scenario is relatively common for real estate interests where cash proceeds of refinancing have been taken or where the property has been fully depreciated. The triggering of this gain can often result in an income tax liability to the transferor that is greater than the potential estate tax savings, or perhaps, the equity values that were the initial motivation for the creation of the GRATs, IDGTs, etc.

In planning for assets with these characteristics, the potential savings in estate, gift and generation skipping transfer taxes must be weighed against the loss of a basis step-up under section 1014 upon death – or even worse, the possibility of incurring an income tax on the built-in gain resulting from use of the planning technique. It is in this context that the benefits of the freeze partnership may take hold. Avoiding these negative income tax consequences can be far more valuable than where the offsetting cost of an increased hurdle rate applies to the freeze partnership. In fact, if properly structured, the costs of the greater hurdle rate can be greatly mitigated. Moreover, as in the context of the reverse freeze described below, the greater hurdle

²³⁵ For a more in depth discussion of the proposals to curtail planning with grantor trusts see generally Stephen M. Breitstone, *Lapsing 2012 Estate Planning Opportunities*, Leimberg, August 7, 2012

rate may even be a benefit that enhances the planning for certain types of assets – particularly, low yielding assets.

1. **Partnership Freeze Solution**

If there is one principle to take away from the foregoing discussion it is that where property is subject to liabilities in excess of basis and such property has been transferred to a grantor trust, the tax consequences upon the death of the grantor are somewhat uncertain. Respected commentators reason that upon the death of the grantor there would be no gain recognized and there may be a basis step-up. However, other commentators believe there may be gain recognition upon death and only in where gain is recognized will there be a basis step-up. It appears that the IRS view is that there would be no gain upon death and no basis step-up.

As described below, the freeze partnership technique can avoid this uncertainty and attendant risk. This technique should be carefully considered among the alternative planning techniques for low basis leveraged real estate. This is because a retained frozen interest in a freeze partnership will be entitled to a basis step-up upon death. Moreover, if properly structured, the liabilities in excess of basis can be allocated to the frozen interest so that the basis step-up can eliminate the inherent gain attributable to liabilities in excess of basis or negative capital.

The freeze partnership can thus transfer appreciation and, perhaps, values out of the estate without foregoing the basis step-up that is necessary to eliminate the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (for real estate owned by a partnership or limited liability company). Moreover, by employing the leveraging techniques described herein it should be possible to overcome the higher hurdle rates necessary to be paid under this technique. Alternatively, the

higher hurdle rates can provide a planning benefit for low yielding assets through the use of the reverse freeze technique.

2. **Elements of the Freeze Partnership under Section 2701**

Briefly stated, the freeze partnership typically has two classes of partnership interests:

1. Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).
2. Junior equity interest, which is entitled to growth and appreciation (like common stock).

In the normal freeze partnership, 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. The transaction is called a freeze partnership because the value of the preferred interest is frozen at the time the junior interest is transferred or otherwise acquired. Assuming the hurdle rate is met and the preferred return is paid, only the junior equity interest appreciates in value over time as the partnership assets appreciate in value.

Intra Family Transfers: Within the family context (meaning with a family controlled entity), section 2701 imposes certain requirements to avoid a deemed gift which can be as much as the entire value of the entity even though a preferred interest is retained. Section 2701 applies where the junior equity interest (or any equity interest under the literal wording of the statute) is transferred in a family controlled corporation or partnership to a member of the transferor's family (generally, of an equal or lower generation). Treasury Regulation section 25.2701-1 sets forth the general rules. Certain technical definitions apply.²³⁶

²³⁶ Partnership freezes are not the only estate freeze techniques which may be subject to Section 2701. If the IRS believes that a note to the grantor of an IDGT is equity rather than debt, it will argue that the trust is a preferred partnership interest subject to section 2701. Unless the retained interest includes a qualified payment right, the

The Regulations Under Section 2701: Treasury Regulation section 25.2701-

1(a) sets forth the scope of section 2701 as follows:

In general—(1) Scope of Section 2701. Section 2701 provides special valuation rules to determine the amount of the gift when an individual *transfers* an equity interest in a corporation or partnership to *a member of the individual's family*. For section 2701 to apply, the transferor or an *applicable family member* . . . must, immediately after the transfer, hold an *applicable retained interest* (a type of equity interest defined in §25.2701-2(b)(1))(emphasis added).

This excerpt highlights key terms which must be understood to work safely within the framework of section 2701. Those terms are “transfer”, “applicable retained interest”, “member of the individual’s family”, and “applicable family member.”

The Requirement of a “Transfer”: As a threshold matter, for section 2701 to apply there must be a “transfer.” Even if no actual gift has occurred, as where there is a transfer for full and adequate consideration, there can be a transfer for purposes of section 2701 resulting in a deemed gift. The term “transfer” includes transactions such as contributions to the capital of a corporation (or partnership), recapitalization of a corporation (or a partnership), redemptions and certain other terminations of an interest in such entities. Thus the creation of a partnership among family members where each member contributes its share to capital must satisfy the requirements of section 2701 to avoid a deemed gift even if no gift was intended.

The Retained Interest: Another element necessary for section 2701 to apply is that the transferor must retain either (i) an “extraordinary payment right” or (ii), in the case of a controlled entity, a “distribution right.” These terms are defined in section 25-2701-2 of the Treasury Regulations.

interest is valued at zero causing the transferred asset to be a taxable gift valued at full fair market value. See *Karmazin v. Comm’r*, T.C. Docket No. 2127-03. See also IRS Priv. Ltr. Rul. 9535026.

Extraordinary payment right is, in general, any put, call, or conversion right, any right to compel liquidation, or any similar right, the exercise or non-exercise of which affects the value of the transferred interest. A call right includes any warrant, option, or other right to acquire one or more equity interests.²³⁷

Distribution right. A distribution right is the right to receive distributions with respect to an equity interest but not any right to receive distributions with respect to an interest that is of the same class as, or a class that is subordinate to, the transferred interest.²³⁸ Thus, it is by operation of this definition that partnerships that provide strictly proportionate allocations are generally not subject to section 2701.²³⁹ Guaranteed payments, as such term is defined in section 707, are not considered distribution rights for purposes of section 2701. Under section 707, guaranteed payments are payments made to a partner by a partnership without regard to the income of the partnership. An example of a guaranteed payment is the payment of interest on capital invested by a partner.

Transferor - Applicable Family Member Definition: Section 2701 applies if there is a transfer by an “applicable family member” to a “member of the individual’s family.”²⁴⁰ Applicable family members generally include the transferor, the transferor’s spouse, either of their ancestors and the spouse of either of their ancestors.²⁴¹ Members of the transferor’s family (“recipients”) generally include the transferor, the transferor’s spouse, any of their lineal descendants and the spouse of any of their lineal descendants.²⁴²

²³⁷ Treas. Reg. § 25.2701-2(b)(3).

²³⁸ *Id.*

²³⁹ Treas. Reg. § 25-2701-2(b)(4) provides as follows: “Rights that are not extraordinary payment rights or distribution rights. Mandatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under section 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights.”

²⁴⁰ IRC § 2701(a)(1)(B).

²⁴¹ IRC § 2701(e)(2).

²⁴² IRC § 2701(e)(1).

Requirement of Family Control: Note that section 2701 does not apply unless the entity in question is a controlled entity.²⁴³ For purposes of Section 2701, a controlled entity is a corporation or partnership controlled, immediately before a transfer or by the transferor and the transferor's applicable family members either directly or by attribution.²⁴⁴ In the case of a corporation, control means the holding of at least 50 percent of the total voting power or total fair market value of the equity interests in the corporation.²⁴⁵ In the case of any partnership, control means the holding of at least 50 percent of either the capital interest or the profits interest in the partnership.²⁴⁶ Any right to a guaranteed payment under section 707(c) of a fixed amount is disregarded in making this determination. In addition, in the case of a limited partnership, control means the holding of any equity interest as a general partner.²⁴⁷

Look Through Rule: There is a "look through rule" which provides that an individual is treated as owning a proportionate share of equity interest held by a corporation, partnership, trust or other entity in which the individual holds an interest.²⁴⁸ Family control of a top tier entity is not required by literal terms of section 2701(e)(3). Private Letter Ruling 9639054 seems to indicate that there is no look through if the top tier entity is not family controlled.²⁴⁹ This is especially important with regard to a potential transfer of membership interests in a corporate general partnership or limited liability company that is the general partner or managing member of a private equity, venture capital, real estate or other fund entity. Typically, the managers of these funds will hold a carried interest and an investor interest in the same fund. Private Letter Ruling 9639054 has been cited for the proposition that if a fund

²⁴³ IRC § 2701(b)(1).

²⁴⁴ IRC § 2701(e)(3) (providing that an individual is treated as holding any interest to the extent such interest is held indirectly by such individual through a corporation, partnership, trust, or other entity).

²⁴⁵ IRC § 2701(b)(2)(A).

²⁴⁶ IRC § 2701(b)(2)(B)(i).

²⁴⁷ IRC § 2701(b)(2)(B)(ii).

²⁴⁸ IRC § 2701(e)(3).

²⁴⁹ IRS Priv. Ltr. Rul. 9639054 (June. 21, 1996).

manager holds a non-controlling interest in an entity that is a general partner of a fund structured as a limited partnership that fund manager will not be treated as holding control for purposes of section 2701. Unfortunately, there is an absence of authority that can be relied upon for this notion. A Private Letter Ruling can only be relied upon by the party who obtained it.

Non-Section 2701 Freezes: Section 2701 is not applicable unless the specific family control requirements are met. Thus, more aggressive, old-style freeze partnerships may still be used where the family members receiving junior equity interests are nephews or cousins. For example, payments do not have to be cumulative and there is no minimum value for the junior equity interests. However, even in these situations care must be exercised to avoid some of the valuation abuses of the past. There is a greater awareness of these types of abuses than there was prior to section 2701.

3. **Structuring the Freeze Partnership: The Forward Freeze**

In the typical situation, unless the provisions of section 2701 are followed, the preferred interest is valued at zero, thereby inflating the value of the transferred junior equity interest to the entire value of the partnership. This treatment acts as a penalty by artificially inflating the amount subject to gift taxation. Retained interests are given a zero value unless they include a right to receive a qualified payment.²⁵⁰ Qualified payment rights are valued according to fair market value (“FMV”). 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.

Qualified payments rights can be: (i) periodic dividends on cumulative preferred stock; (ii) any comparable payment from a partnership interest; or (iii) any other payment where

²⁵⁰ IRC § 2701(a)(3)(A).

an irrevocable election is made to treat the other payment as a qualified payment.²⁵¹ The payment of any qualified payment made (or deemed 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.²⁵²

The extremely low rates of interest that are permitted in both the GRAT and the IDGT are in stark contrast with the rates of return required to be paid on a preferred interest in a section 2701 entity freeze. One source of guidance for how to determine the appropriate yield for a preferred interest in a closely held entity is set forth in Revenue Ruling 83-120.²⁵³ While Revenue Ruling 83-120 predates section 2701, it is nevertheless instructive. In general, Revenue Ruling 83-120 adopts a facts and circumstances approach. However, it does specifically look to a number of criteria to determine the appropriate market rate of return. These criteria include yield, preferred return coverage, dissolution protection, and to a lesser extent, voting rights and lack of marketability. The liquidation preference apparently reduces the extent to which marketability has a negative impact on fair market value. Market conditions are thus the starting point for determining the appropriate return on preferred interests. One reputable appraisal firm provided the following table which enumerates market returns on preferred stocks of certain publicly traded real estate holding entities:

²⁵¹ IRC § 2701(c)(3).

²⁵² IRC § 2701(d)(2)(C); Treas. Reg. § 25.2701-4(c)(5).

²⁵³ 1983-2 C.B. 170.

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

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In the context of a privately held business entity, the lack of marketability and potentially greater risk profile would likely require somewhat higher rates of return – to be determined by appraisal. The comparatively high rates of return that must be paid on preferred interests to avoid the negative gift tax consequences under section 2701 are the reason the entity freeze is often referred to as a “leaky freeze.” This term alludes to the fact that compared to other types of freeze techniques, where the returns that must be paid on the frozen interest are artificially low since they are tied to the AFR, the return that must be paid on the retained senior preferred interest to avoid a deemed gift under section 2701 must be a market rate of return for similar investments.

It may take considerable structuring to make the entity freeze work as a freeze. There are a number of methods of working around the high rate of return that must be paid on

the preferred interests – if that is desired. With the modest size estate, the holder of the preferred interest may desire the higher rate of return. However, with the larger estate, the planning will typically warrant paying the lowest return possible on the retained preferred interest. Otherwise, the estate may continue to build.

Among the methods to reduce the payments in respect of the preferred would be leveraging up the equity. By increasing the debt in the capital structure there will be less equity to accrue the preferred return. Typically the debt would bear a lower rate of interest. In some instances, it may be possible to borrow from a related party or family member. In such instances it may be desirable to have the loan bear interest at the applicable federal rate. To illustrate this method assume that real estate is contributed to a Freeze LP with a fair market value of \$10,000,000, an adjusted basis of \$1,000,000, and it is subject to a mortgage of \$8,000,000. The net equity is \$2,000,000 and there are \$1,800,000 in the senior/preferred capital account and \$200,000 in junior/common capital account. If it is not leveraged then the preferred return at an 8% rate is \$144,000. However, if it is leveraged and the Partnership takes out a \$1,500,000 mid term AFR Loan and distributes the proceeds to the senior/preferred then the net equity is \$500,000 and there are \$300,000 in the senior/preferred capital account and \$200,000 in junior/common capital account. The preferred return at a 9% rate is \$27,000, and the interest on the AFR Loan (.95%) is \$14,250, for a total leveraged return to senior/preferred is \$41,250, which is \$102,750 less than the unleveraged return of \$144,000.²⁵⁴

Unleveraged		Leveraged	
Asset (FMV)	\$10,000,000	Asset (FMV)	\$10,000,000
Mortgage	<u>(\$8,000,000)</u>	Mortgage	(\$8,000,000)
Equity	\$2,000,000	AFR Loan	<u>(\$1,500,000)</u>
		Equity	\$500,000
Capital Accounts		Capital Accounts	
Senior	\$1,800,000		

²⁵⁴ See Stephen M. Breitstone, *Estate Planning for Investment Real Estate: Don't Forget the Income Tax Side*, NYU, 71st Institute on Federal Taxation (2012).

Junior	<u>\$200,000</u>	Senior	\$300,000
	\$2,000,000	Junior	<u>\$200,000</u>
			\$500,000
Preferred Return	\$144,000	Preferred Return	\$27,000
		Interest on Loan	<u>\$14,250</u>
		Total Return to Senior	\$41,250

Alternatively, it may be possible to carve out small slice of equity that accrues the preferred return but is allocated the liabilities that result in the negative capital. Different possibilities exist. Below is a discussion of the disguised sale rules under section 707 of the Code. Leveraging up the capital structure shortly after the formation of the partnership can in some instances be considered to be a disguised sale. However, it should be possible in most instances to structure around disguised sale treatment.

One method to create a class of equity that accrues a preferred return but which is relatively “thin” would be to draft a partnership agreement where the lion’s share of the equity is allocable to the common interests. A small slice of equity would be attributed to the preferred interest. By agreement, it may be possible to allocate all of the liabilities, and thus, negative capital to the preferred interest. A number of cases have held that where a taxpayer sells property encumbered by a liability but the buyer and seller agree that as between themselves, the seller shall have sole responsibility for payment of the liability, the liability is not “assumed or taken subject to” by the buyer within the meaning of Treas. Reg. § 15A.453-1(b)(3)(i).²⁵⁵ These

²⁵⁵ See *Stonecrest v. Commissioner*, 24 T.C. 659 (1955); see also *Republic Petroleum Corp. v. United States*, 613 F.2d 518 (5th Cir. 1980); *United Pac. Corp. v. Commissioner*, 39 T.C. 721 (1963); *Estate of Lamberth v. Commissioner*, 31 T.C. 302 (1958). In 1981, the Service issued Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) in an attempt to reverse the results in the *Stonecrest* line of cases. Temp. Treas. Reg. § 15A.453-1(b)(3)(ii) requires that a wraparound mortgage be treated the same as if the buyer had assumed or taken the property subject to the seller’s mortgage, even though title does not pass and the seller remains liable on the mortgage. However, the Tax Court invalidated this temporary regulation in *Professional Equities, Inc. v.*

cases would seem to support allocating the liabilities to the preferred interest holder even though a relatively small portion of the equity accrues a preferred return.

Section 2701(d) provides for a deemed gift if and to the extent qualified payments are not paid within a four year period of when they were accrued. In general, the deemed gift will be the amount of the unpaid qualified payments increased by a compounding rate equal to the underlying payment rate of the qualified payment, provided the amount of the gift does not exceed the equity value of the underlying entity.²⁵⁶

If the requirements of Section 2701 are satisfied, the retained preferred interest will not be valued at zero but rather the fair market value of the retained preferred interest is deducted from the fair market value of the partnership capital. The difference is the gift tax value of the junior equity interest. This calculation is made in accordance with Treasury Regulation 25.2701-3. The regulations contain certain biases, which biases can have a significant impact upon the planning.

The Treasury Regulations employ the “subtraction method,” a four-step method for determining the value of the transferred interest.

Step 1 – Value the entire family-held interest.

Step 2 – Subtract the value of senior equity interests held by the family.

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 Treasury Regulation 25.2701-3(b)(4). The value of the junior equity interest, so determined, less any consideration paid for that interest, will be a taxable gift.

Commissioner, 89 T.C. 165 (1987). See generally Silverman and Nocjar, *PLI, Disguised Sale Rules* (May 2011).

²⁵⁶ IRC § 2701(d).

Notwithstanding the foregoing calculation, section 2701 deems the junior equity interest to have a value of not less than ten-percent (10%) of the sum 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.

SPECIAL VALUATION CHALLENGES UNDER SECTION 2701 REGULATIONS

Section 25.2701-3(b)(1) goes beyond the statutory requirements by imposing an additional valuation stricture. In determining the starting point for the subtraction method, the regulations require that the fair market value of all family held interests must be determined “by assuming that the interests are held by one individual, using a consistent set of assumptions.” This assumption is apparently designed to preclude valuation discounts such as discounts for lack of control and lack of marketability from being applied in Step 1 of the subtraction method. If the entity is family controlled and all family held interests are deemed held by one individual that individual must not hold a minority or non-controlling interest. Likewise if all family held interests are considered to be held by one individual, it would normally be the case that that individual would have the ability to compel a liquidation of the entity. If an individual can compel a liquidation, there would normally be no discount for lack of marketability since that individual would usually have the ability to force a sale of the entity’s underlying assets. Note that if a nonfamily member’s consent would be required to compel liquidation, even if the entity is family controlled, the family may not have the ability to unilaterally compel a liquidation.²⁵⁷

Step 1’s requirement that all family-held interests be valued as though they are “held by one individual” probably represents a position which was once taken by the IRS but which has subsequently been reversed. For many years prior to the issuance of the section 2701

²⁵⁷ See generally Milford B. Hatcher, Jr. & Gregory E. Kniesel, *Preferred Limited Partnerships – Now the FLPs of Choice?*, 89 J. Tax’n 325, 333 (Dec. 1998); Rev. Ruling 93-12. See Milford B. Hatcher, Jr., *Preferred Partnerships – The Neglected Freeze Vehicle* (2002).

regulations the IRS contended that all family-held interests should be aggregated for valuation purposes.

This so-called “family attribution” argument was still the formal litigation position of the IRS when the section 2701 regulations were issued in 1992. However, the courts had repeatedly rejected the IRS’s family attribution argument.²⁵⁸ Approximately one year after the promulgation of the section 2701 regulations the IRS relented and acknowledged in Revenue Ruling 93-12 that family attribution is inappropriate and that intra family discounting can be appropriate.²⁵⁹

The issuance of Revenue Ruling 93-12 was probably a turning point in tax planning. It spawned the widespread use of family partnerships and other family controlled entities to create discounts.

Since the issuance of Revenue Ruling 93-12 the IRS has attempted to constrain the use of family controlled partnerships and other entities to create discounts and to facilitate tax planning. More recently, the IRS has had some success upsetting ill conceived and poorly executed estate plans that attempt to create discounts by employing family partnerships where no significant business or nontax purpose was a driving force for the plan.²⁶⁰ Nevertheless, the cases where the IRS has succeeded represent the exception to the general rule that there is no proper legal basis for the IRS to impose a family attribution rule absent an act of legislature. It is likely that the provision in Treasury Regulation 25.2701-3(b)(1) imposing a form of family attribution would be vulnerable to a judicial challenge. The “family attribution” approach taken

²⁵⁸ See *Estate of Lee v. Comm’r*, 69 T.C. 860 (1978); *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981) (en banc.); *Estate of Andrews v. Comm’r*, 79 T.C. 938 (1982); *Minahan v. Comm’r*, 88 T.C. 492 (1987) (costs assessed against the IRS for its continued litigation of family attribution); and *LeFrak v. Comm’r*, T.C. Memo. 1993-526.

²⁵⁹ 1993-1 C.B. 202.

²⁶⁰ See *supra* note 41

in Step 1 thus appears to be an historical vestige which reflects a position which is no longer being taken by the IRS and which has consistently been rejected by the courts.

It should be noted that under the subtraction method the absence of discounting may not have an overwhelming impact upon valuations. Ultimately, the undiscounted value would be attributed to the retained senior equity interest. Business appraisers tend not to impose large discounts upon preferred interests due to their inherent attributes.

The regulations contain an exception to the family attribution rule for “contributions to capital.” In the case of a contribution to capital, Step 1 permits the use of fair market value as an exception to the family attribution rule. This exception seems to apply to property contributed to a partnership which would normally not be discounted upon contribution. Under normal partnership accounting principles, partners’ capital accounts are credited with the fair market value of contributed property. This rule is set forth in the section 704(b) regulations.²⁶¹ Yet if the property contributed is an interest in an entity or a fractional interest, it would appear that normal valuation discounts would be applicable as the measure of the contribution to a freeze entity.

1. Income Tax Consequences of the Partnership Freeze

There are significant income tax consequences to the formation and operation of a freeze partnership or LLC. A command of the partnership income tax rules contained in Subchapter K of the Code is required to properly design and implement the freeze. The taxation of partnerships is one of the more complex areas of the Internal Revenue Code. Failure to involve a professional with the necessary income tax expertise can result in unintended and, perhaps, unfortunate tax consequences. Moreover, a working knowledge of Subchapter K can be valuable in maximizing this technique.

²⁶¹ Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

One of the principal concerns arises from the fact that this technique is most advantageous when planning for high leverage low basis property – especially real estate. This is where income tax planning and the estate planning converge. As already discussed, the stakes for obtaining a basis step-up upon death, and to avoid gain recognition during lifetime, are much greater for this type of asset. The freeze partnership can facilitate both objectives.

The objective is to structure contributions of appreciated property to the partnership so that the maximum amount of built-in gain and liabilities in excess of basis (or negative capital) will be allocated to the senior preferred interest. While Subchapter K has an operating framework that can facilitate this objective, it will not necessarily happen by itself. Careful structuring is required.

Contributions of appreciated property to a partnership are generally entitled to nonrecognition treatment pursuant to section 721.

However, there are two principal areas of sensitivity that can trigger gain. Care must be exercised to avoid a capital shift and a liability shift.

Capital Shifts

A capital shift results when a contribution of property by one partner enhances the capital value of one partner's interest at the expense of another's.

Determination of whether a capital shift has occurred in a recapitalization requires determining the amount each of the senior generation member and the junior generation member would receive if the partnership were to liquidate immediately prior to the recapitalization, assuming all of the partnership assets were sold on that date for their fair market values and the proceeds of the sale were distributed in complete liquidation of their partnership interests. If immediately following the recapitalization the same liquidation test were applied, the amounts

each of the partners would receive should remain unchanged. If members of the junior generation would receive more post-recapitalization than pre-recapitalization, then a shift of capital to such members has occurred. Such a shift of capital could result in a taxable gift or a taxable grant of a capital interest as compensation for services performed.

In a freeze partnership the junior equity interest has many of the characteristics of a partnership profits interest. While the grant of a mere profits interest in partnership is generally not considered a taxable event, if the profits interest is accompanied by a shift of partnership capital to the recipient, there will be a taxable event. This is the case whether or not the grant is in connection with the performance of services. If the grant is in connection with the performance of services, the recipient will be taxable on the value of the interest so received. If the grant is not in connection with the performance of services, it will likely be a gift. Within the context of a family controlled business entity it is possible there will be some combination of compensation and gifting.

The taxation of grants of a partnership interest for services presents significant conceptual difficulties for both the government and taxpayers. Yet these rules are directly relevant to the question of whether there has been a capital shift which impacts the taxation of freeze partnerships.

The taxation of compensatory grants of partnership interests has been one of the most difficult areas for the government to develop a comprehensive and intellectually pure set of strictures.²⁶² The taxation of grants of partnership profits interests, which is often integral to real estate partnership structures, has posed administrative and conceptual difficulties for at least four decades. The most recent administrative attempt to regulate this area came in 2005 and has

²⁶² See generally Stephen M. Breitstone & José L. Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*, NYU, 66th Institute on Federal Taxation, Chapter 8 (2008).

largely stalled.²⁶³ Moreover, these transactions come dangerously close to the types of transactions that have been firmly in the sights of the Obama Administration through its proposals to increase the incidents of taxation of so-called “carried interests.” While these measures have not passed as of the date of this writing, they may resurrect themselves in a subsequent Congress.²⁶⁴

Closely analogous to the taxation of the formation of a freeze partnership is the taxation of a partnership recapitalization. Either transaction can be subject to section 2701. If a junior equity interest is to be granted within the framework of an existing partnership in order to create the frozen preferred interests, it will likely be necessary to elect to book-up the capital accounts of the partners under section 1.704-1(b)(2)(iv)(f) and (g) in order to prevent an unintended capital shift. Such a book-up is a restatement of partners’ capital accounts to reflect the liquidation value of their interests as the time of the book-up event. Generally, it is necessary for there to be a grant of a partnership interest in connection with a contribution of capital to the partnership, a grant of a compensatory profits interest or a liquidation or redemption of a partnership interest in connection with a distribution of capital in order to be able to book-up the capital accounts under this provision.²⁶⁵

²⁶³ In 2005, when the proposed section 83 regulations were introduced, Treasury also issued a proposed revenue procedure that would make Rev. Proc. 93-27 and Rev. Proc. 2001-43, *Doc 2001-20855, 2001 TNT 150-11*, obsolete on finalization of the regulations (see Notice 2005-43, 2005-1) C.B. 1221, *Doc 2005-11236, 2005 TNT 98-37*). The new rules would apply to grants of compensatory profits interest issued on or after the date of the final regulations. As of this writing, the final regulations have not been issued and it appears that they are neither imminent nor likely to resemble the proposed regulations.

An in-depth discussion of past and present law governing the taxation of partnership interests is set forth in Breitstone & Berra, *Practical Drafting Considerations for Partnership Agreements and Operating Agreements in the Closely Held Context*.

²⁶⁴ See generally Breitstone, *Carried Interest Bill -- Impact on Real Estate Partnerships*, 2010 TNT 45-5, March 9, 2010; Breitstone, *Carried Interest Bill -- a ‘Death Trap’ for Real Estate Partnerships*, 2009 TNT 118-8, June 22, 2009.

²⁶⁵ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)

Liability Shifts

Gain can also be triggered upon the contribution of property to a partnership or upon a recapitalization if there is a shift in the manner in which partnership liabilities are shared among the partners under the rules set forth in section 752 and the regulations there under. It should be noted that, in general, if the partnership liabilities are nonrecourse (meaning recourse is limited to the property that secures the debt) and are not guaranteed by any of the partners, a liability shift, in general, will not occur to trigger gain recognition at the time of contribution or reorganization. However, in other situations, a liability shift may occur.

Even if there is no liability shift upon the contribution of low basis leveraged property to a partnership, obtaining a full basis step-up that will eliminate the built-in gain attributable to liabilities in excess of basis requires additional structuring. If the junior equity is to be held by a grantor trust, or if the junior equity is to be issued initially to the senior generation and then subsequently gifted to the junior generation, a portion of the liabilities will be allocated to the junior equity. To the extent the junior equity is then transferred, the allocable share of liabilities will come along to the transferee. If the transfer is by reason of an outright gift to an individual member of the junior generation, such a gift may be treated as a part sale/part gift triggering immediate recognition of gain on the liabilities in excess of basis. This consequence can be avoided by making the gift or transfer to a grantor trust since the grantor will be considered to have retained ownership of the transferred interest for income tax purposes. However, since a portion of the liabilities will be deemed allocable to the transferred interest when the grantor trust status ends, such as upon the death of the grantor, a portion of the step-up may be lost. It is also possible that some gain will be recognized at that time, depending upon your views on this topic.²⁶⁶ This is due to the fact that the grantor will be considered to have one

²⁶⁶ See discussion supra at note 22.

partnership interest and one capital account. If the interest is actually owned by the senior generation or is deemed owned by that generation under the grantor trust rules, any junior interest given away will be considered to be a portion of the senior generation's initial partnership interest including a share of the liabilities that otherwise would have been allocable to the senior preferred interest. To avoid this result, at least two separate partnership interests must be created. One should be issued in exchange for the encumbered property. Normally, this will be the senior equity interest. The other interest should be granted to a different taxpayer in exchange for cash or other unencumbered assets. The interest can even be granted to a nondisregarded entity owned mostly by the senior grantor. Since that latter interest would be granted in exchange for unencumbered property or cash, it should not be allocated a share of the liabilities.

Even where the ultimate transferee of the junior interest is to be a grantor trust, it should be possible to structure the partnership so that the liabilities will remain allocated to the senior generation. For example, if the junior equity interest is initially issued to a nondisregarded entity such as an LLC, and that interest is granted in exchange for a contribution of capital by the junior family members or a grantor trust for their benefit, it should be possible to force all of the negative capital to remain with the senior generation. The death of the senior generation should result in a basis step-up that eliminates that negative tax history.

CONTRIBUTIONS OF LOW BASIS LEVERAGED REAL ESTATE TO A PARTNERSHIP

Generally, section 721 affords nonrecognition treatment upon the contribution of appreciated property to a partnership. This treatment applies whether the contribution occurs at the time of formation or to an existing partnership. It also applies regardless of the percentage of

the partnership received in exchange for the contribution.²⁶⁷ If the contributed property has a fair market value in excess of its adjusted income tax basis, section 704(c) will come into play to require that certain allocations be made to avoid shifting the precontribution gain to the noncontributing partner.

Under section 752, an assumption of debt by the partnership from contributed property is treated as a distribution of cash to the contributing partner. Under the regulations, simultaneously with the deemed distribution there will be a deemed contribution reflecting the contributing partner's share of partnership indebtedness determined immediately after the contribution. If the partner is allocated a share of post-contribution indebtedness not less than the deemed distribution plus any basis in the contributed property there will be no gain recognition at the time of contribution. If the contributing partner's net debt share is reduced in connection with the contribution, and the contributed property is subject to liabilities in excess of basis, the contribution will result in a "debt shift." The net reduction in the contributing partner's share of debt can result in taxable gain under section 731(a). Under some circumstances, there can also be ordinary income if the property is subject to depreciation recapture under section 751.

Section 752 governs how the partnership indebtedness is allocated among the partners. Recourse debt is allocated to the partner who bears the economic risk of loss. A different set of rules applies for nonrecourse debt since the partners do not bear the risk of economic loss.

Normally when property is contributed subject to nonrecourse indebtedness, the default provisions of the section 752 regulations preclude such a debt shift. However, if the

²⁶⁷ Compare with section 351 which conditions nonrecognition upon transfer of appreciated property to a corporation upon the transferors having "control" immediately after the contribution. Control is defined as ownership of 80 percent or more of the combined classes of stock immediately after the contribution.

property is subject to recourse indebtedness, if the indebtedness is guaranteed by one of the partners, or if the lender is a related party to the partnership, a debt shift is a possibility. Normally, in the context of a freeze partnership where the contributing partner is a member of the senior generation making a contribution in exchange for a preferred partnership interest, if the contributing partner is personally liable for the debt or is a guarantor, there will be no debt shift because the liabilities will be allocated to the contributing partners.

1. **Allocations of Partnership Liabilities**

Section 752 governs the manner in which partnership liabilities will be allocated among the partners. In general, section 752 maintains parity between inside and outside basis by coordinating adjustments to the partners' outside bases with increases and decreases in partnership liabilities. The liability-sharing rules of section 752 closely track the economic effect analysis under the 704(b) regulations.

The sharing of recourse liabilities is determined by identifying which partners would bear the economic risk of loss based on the consequences of a constructive liquidation (a hypothetical event in which all partnership assets become worthless and the partnership liquidates). Generally, this can be determined by asking, if the partnership defaulted on its obligation, to what extent (if any) would a partner be obligated to pay the liability from personal funds without the right to reimbursement.²⁶⁸ If no partner would bear the economic risk of loss the liability is classified as nonrecourse. The rules governing the allocation of nonrecourse liabilities are very flexible and taxpayer friendly. The rules generally allow such liabilities to be allocated based on the manner in which the partners share the profits that would presumably be used to repay such liabilities.

²⁶⁸ See IRC § 752(c); Treas. Reg. § 1.752-1(d)-(e).

Under section 752, a liability affects the outside basis only to the extent that it creates or increases the basis of the property or gives rise to a current deduction or a nondeductible non-capital expenditure.²⁶⁹ A liability is recourse to the extent that any partner bears the economic risk of loss with respect to such liability.²⁷⁰ A partner's share of partnership recourse liabilities equals the portion of such liabilities for which he bears the economic risk of loss.²⁷¹ In general, a partner bears the economic risk of loss with respect to a partnership liability to the extent that the partner would be obligated to make a net payment or a net contribution with respect to such liability upon a hypothetical liquidation of the partnership.²⁷² A partnership liability is nonrecourse to the extent that no partner bears the economic risk of loss for that liability.²⁷³

2. Allocations of Nonrecourse Debt

Under the section 752 regulations, nonrecourse liabilities are allocated in three tiers - the first two are priority tiers. The first tier looks to a partner's share of "minimum gain" as determined under section 704(b).²⁷⁴ In general, minimum gain is the amount of gain that would be recognized if property subject to nonrecourse debt were sold for the amount of the indebtedness. That is the minimum amount of gain that would be recognized upon such a disposition. Each partner has a share of minimum gain which is based upon the previous nonrecourse deductions allocated to that partner and any proceeds from nonrecourse financings distributed to that partners.²⁷⁵

²⁶⁹ See Treas. Reg. § 1.752-1(a)(4)(i) (liability defined); Rev. Rul. 88-77; Rev. Rul. 95-26, 1995-1 CB. 131 (short sale of securities).

²⁷⁰ See Treas. Reg. § 1.752-1(i); Treas. Reg. § 1.752-2(f), Ex. 5.

²⁷¹ Treas. Reg. § 1.752-2(a).

²⁷² See Treas. Reg. §§ 1.752-2(b)(1), (5), (6); -2(b)(2)(i).

²⁷³ Treas. Reg. § 1.752-1(a)(2).

²⁷⁴ Treas. Reg. § 1.752-3(a)(1).

²⁷⁵ Treas. Reg. § 1.704-2(g)(1)(i).

The second tier is a partner's share of partnership minimum gain as determined under 704(c) regulation concerning allocation of nonrecourse deductions. This tier is most relevant to the creation of freeze partnerships for leveraged appreciated real estate with low income tax basis. A partner's share of minimum gain is the amount of taxable gain that would be allocated to a partner under 704(c) principles if the partnership disposed of all property subject to nonrecourse liabilities in a taxable transaction in full satisfaction of such liabilities and for no other consideration.²⁷⁶

In order to understand the allocation of nonrecourse indebtedness secured by appreciated contributed property, it is necessary to have some understanding of section 704(c). Section 704(c)(1)(A) requires that income, gain, loss and deduction with respect to contributed property be shared among the partners so as to take account of any difference between basis and value at the time of contribution. The Regulations provide detailed rules for allocation with respect to "704(c) property" which is defined as property which has a book value different from its tax basis at the time of contribution.²⁷⁷ In general, such allocations must be made using a reasonable method that is consistent with the purpose of 704(c), i.e. to prevent shifting of built-in gain or loss.²⁷⁸

To understand the workings of section 704(c) it is necessary to understand how capital accounts are maintained under section 704(b) and the regulations there under.²⁷⁹ The

²⁷⁶ Treas. Reg. § 1.752-3(a).

²⁷⁷ Treas. Reg. § 1.704-3(a)(3).

²⁷⁸ Treas. Reg. § 1.704-3(a)(1).

²⁷⁹ The regulation set forth three alternative methods that are deemed reasonable methods for allocations to reflect the reconciled book and tax bases.

Traditional Method

The first method is known as the "traditional method." The traditional method requires that any built-in gain or loss attributable to contributed property be allocated to the contributing partner to the extent possible. *See* Treas. Reg. § 1.704-1(b)(4)(i),-1(b)(5), Ex. 17. Under the traditional method, there is a prohibition upon allocating more than the normal tax items that would otherwise be available. This rule is known as the ceiling rule. Thus, if the book depreciation allocable to the noncontributing partners is greater than the available tax depreciation, the

limit on what can be allocated to the noncontributing partner would be the amount of tax depreciation. *See* Treas. Reg. § 1.704-3(b)(1).

If the ceiling rule applies, phantom income may be allocable to the noncontributing partners. This is because the noncontributing partners (generally the partners who contribute cash) may be deprived of the full depreciation deductions to which they would otherwise be entitled. This can create certain distortions that may be significant in structuring the partnership. Of course, if these distortions occur between a grantor and a grantor trust, this would not likely be a concern. Under the traditional method, ceiling rule distortions will be remedied only upon the sale or liquidation of the partners' partnership interests.

Traditional Method with Curative Allocations

The second section 704(c) method allowed under the regulations is the "traditional method with curative allocations." The regulations permit reasonable curative allocations to reduce or eliminate distortions attributable to the ceiling rule. A curative allocation is any allocation of tax items that differs from the allocation of corresponding book items. *See* Treas. Reg. § 1.704-3(c)(1). Generally, a curative allocation is considered reasonable only if it does not exceed the amount necessary to offset the effect of the ceiling rule and consists of tax items of the same type or character as the item limited by the ceiling rule. *See* Treas. Reg. § 1.704-3(c)(3). Notwithstanding the character restriction, a curative allocation of gain from sale of 704(c) property is generally considered reasonable to cure ceiling-rule limitations on depreciation. *See* Treas. Reg. § 1.704-3(c)(3). If the partnership does not have sufficient tax items to cure the ceiling rule disparity in the year it occurs, subsequent curative allocations to remedy the initial disparity are permitted only if made either (i) over a reasonable period (such as the property's economic life), or (ii) on the sale of the contributed property.

Remedial Allocation Method

The third section 704(c) method is the "remedial allocation method." This method is a variation of a deferred sale approach. Under a deferred sale approach, the partnership would be treated as if it had purchased the contributed property for its fair market value on the date of contribution, but the contributing partner's built-in gain or loss would be deferred until subsequent events, e.g., disposition of the property. Because of character and timing differences, the deferred sale approach was considered too generous to the contributing partner so instead the regulations provide for the remedial allocation method which accomplishes a similar result as the deferred sale approach with respect to the noncontributing partners. Noncontributing partners receive, in effect, a cost basis in their share of the contributed property. This approach eliminates ceiling rule distortions by creating fictional tax items that exactly offset the ceiling-limited items in amount and character. *See* Treas. Reg. § 1.704-3(d)(4). In the case of depreciable 704(c) property a special rule applies for the purposes of recovering book basis under the remedial allocation method. *See* Treas. Reg. § 1.704-3(d)(2),-3(d)(7), Ex. 1.

The remaining built-in gain or loss at the time of the distribution depends on the 704(c) allocation method used by the partnership. *See* Treas. Reg. § 1.704-4(a)(5), Ex. 2 (traditional method); -3 (remedial allocation method).

Section 704(c) can also trigger tax consequences that must be considered if the contributed property is to be distributed within the seven year period following its contribution. Section 704(c)(1)(B) may require recognition of gain if 704(c) property is distributed to another partner within seven years of contribution. Section 704(c)(1)(B) is intended to prevent circumvention of the 704(c) allocation rules when property contributed by one partner is distributed to another partner within seven years after contribution. If the provision applies, the contributor recognizes taxable gain or loss equal to the amount that would have been specially allocated to him under 704(c) upon a deemed sale of the property for its fair market value at the time of the distribution. *See* Treas. Reg. § 1.704-4(a)(1).

Like section 704(c)(1)(B), section 737 is intended to prevent circumvention of the 704(c) allocation rules. Section 737 can trigger gain recognition to a contributing partner when other partnership property is distributed to the contributing partner within the seven year period following the contribution. If the provision applies, the contributor recognizes a taxable gain equal to the lesser of the excess distribution or the partner's net precontribution gain. *See* IRC § 737(a).

Another section 704(c) rule impacts the ability to deduct losses attributed to contributed property. In 2004, Congress amended section 704(c)(1) to prevent a potential shifting of losses among partners in connection with a contribution of built-in loss property. Under section 704(c)(1)(C), a built-in loss may be taken into account only by the contributing partner and not by other partners. The term built-in loss is defined as the excess of the adjusted tax basis of the contributed property over the fair market value of such property at the time of contribution. With respect to non-contributing partners, such property is treated as having a basis equal to its fair market value at the

regulations under section 704(b) require capital accounts of partners who contribute appreciated property to be credited for the fair market value of the appreciated property – not the tax basis. It is thus necessary to maintain one set of books to reflect the fair market value of appreciated property and the depreciation deductions computed on the basis of that fair market value. Simultaneously, books must be maintained reflecting historical income tax basis and depreciation deductions calculated on that amount. Section 704(c) is designed to create allocations that will bring the book tax basis and historical cost tax basis into harmony – over time. If they are not ultimately brought into harmony, section 704(c) will, in general, require gain to be allocated to the contributing partner upon a disposition of the contributed assets.

The third tier of partnership liabilities is referred to as “excess nonrecourse liabilities,” i.e. the residual category left after initially allocating the partnership’s nonrecourse liabilities to the two priority tiers. These liabilities may be allocated in any manner consistent with the manner in which any significant partnership item is allocated provided the allocation of that item has substantial economic effect as determined under the regulations under section 704(b).²⁸⁰

A partner’s share of nonrecourse liabilities equals the sum of his shares of partnership minimum gain, 704(c) minimum gain and excess nonrecourse liabilities. In accordance with the *Crane* rule, the regulations include the nonrecourse liabilities in the partnerships inside basis and the partners’ outside bases. The underlying theory is that a partner who receives a disproportionate allocation of nonrecourse deductions should also receive a corresponding share of the *Crane* basis generated by the nonrecourse liability.

time of contribution. When the contributing partner’s partnership interest is transferred or liquidated, any remaining section 704(c) built-in loss is eliminated. IRC § 704(c)(1)(C).

²⁸⁰ See Treas. Reg. § 1.752-3(a).

3. **Coordinating Sections 704(c) and 752**

Upon the formation of the freeze partnership where leveraged real estate with a low income tax basis is contributed in exchange for the senior preferred interest, it is generally the case that the section 704(c) minimum gain will cause the nonrecourse debt to be allocated to the contributing partner. A partner who contributes property subject to a nonrecourse liability is allocated an amount of liability at least equal to the section 704(c) minimum gain (i.e. the excess of the nonrecourse liability over the tax basis of the property).²⁸¹ This taxable gain is the minimum amount that would be allocated to the contributing partner if the encumbered property were sold for no consideration other than relief of the nonrecourse liability.

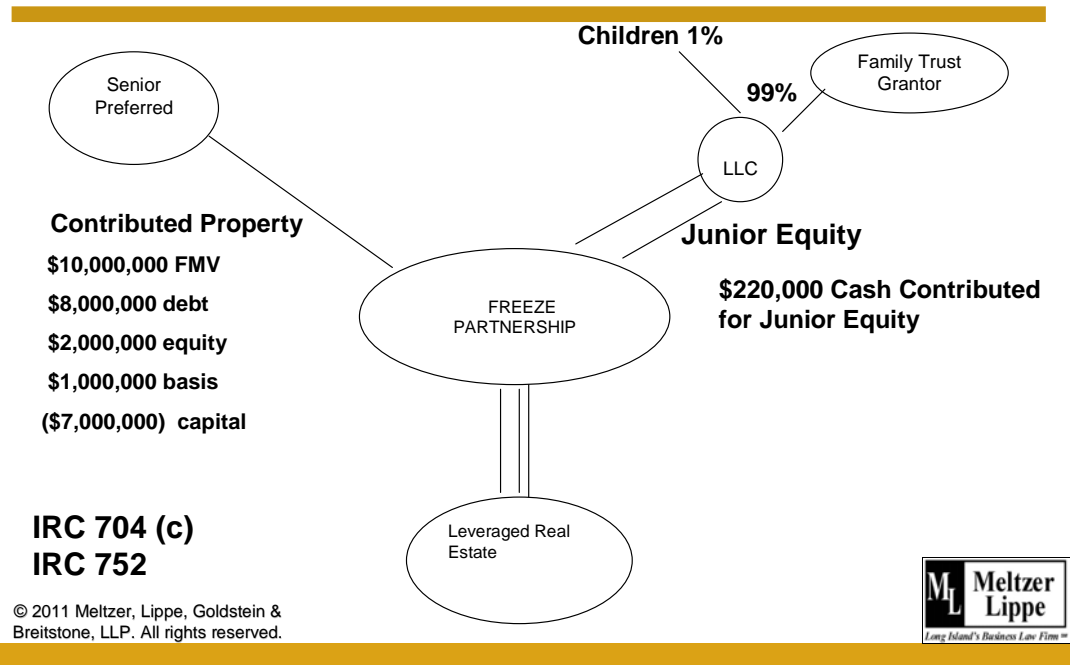
4. **Allocating Liabilities to the Holder of the Preferred Interest**

For the section 752 rules to work within the framework of a freeze partnership the entity must be treated as a partnership for income tax purpose at its inception. Thus, for example, if there is a partnership between the grantor and a grantor trust, the partnership will be a disregarded entity for income tax purpose leaving a lack of clarity as to how the liabilities are to be allocated. It is thus necessary to ensure that the partnership is not a disregarded entity. In order to obtain the maximum basis step up under section 1014 the liabilities must be allocated to the senior holder of the preferred interest. Only if the entity is treated as a partnership for tax purposes (not a disregarded entity) will it be clear that there will be a basis step-up to the estate for the entire share of liabilities in excess of basis of the contributed property that would have been treated as if transferred from the senior interest holder.

The following is an example of a structure that should be able to avoid these uncertainties:

²⁸¹ Treas. Reg. § 1.752-3(a)(2)

Structure to keep Liabilities with Senior



In this example, the partnership will not be a disregarded entity. It is structured so that it will be treated as a partnership for income tax purposes from its inception. This is accomplished by creating a nondisregarded entity to be the initial partner who will acquire the junior equity interest. There are a number of ways to accomplish this goal. However, it is important to note that only the low basis leveraged property should be contributed in exchange for the senior preferred ownership interest. Different property, presumably unencumbered property or cash, should be contributed to the nondisregarded entity formed to hold the junior equity interest. The nondisregarded entity would, in turn, contribute this property to the partnership in exchange for the junior equity interest. This other property can be contributed either by the grantor or by other family members. If it is contributed by the grantor, the grantor would receive, in exchange, an ownership interest in the nondisregarded entity. In the example, that is a 99% interest – although there is no magic to that percentage. The grantor could then

either gift or sell that interest to the grantor trust. All of the income tax items (except for the 1% owned by others) would flow through to the grantor either directly as the holder of the senior preferred interest, or indirectly from the nondisregarded junior equity interest holder through the grantor trust as grantor. The separate existence of the junior equity interest holder should be sufficient to treat the partnership as a freeze partnership with two partners for income tax purpose. One partner would be the grantor. By operation of the second tier rule for nonrecourse liabilities under section 752, all of the liabilities to which the contributed property was subject at the time of contribution would be allocated to the grantor's senior preferred interest. This interest would be included in the grantor's estate for estate tax purposes upon the death of the grantor which should result in a basis step-up for the entire liability share under section 1014.

5. Leveraging the Freeze - Rules Governing Disguised Sale of Property under Section 707(a)(2)(B)

Maximizing leverage in a freeze partnership can greatly improve the economics of the freeze. By adding debt into the partnership capital structure the equity required to assure a market value "qualified payment" stream can be minimized. This can make the freeze partnership much more competitive with installment sales to IDGT which only need to accrue interest at the applicable Federal rate of Section 1274 of the Code. However, additional leverage with the partnership freeze may raise challenges under the disguised sale rules of Section 707(a) of the Code.

6. Disguised Sales of Property Under § 707(a)(2)(B)

The disguised sale of property rules contained in Section 707(a)(2)(B) are of concern when contributing appreciated property to a freeze partnership. These rules are of particular concern where property is contributed within two years of a nonrecourse borrowing. It

is also of concern if qualified payments can be viewed as sale proceeds rather than a reasonable return on the senior preferred capital.

Congress enacted Section 707(a)(2)(B) in the Deficit Reduction Act of 1984.²⁸²

Section 707(a)(2)(B) reads:

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, such transfers shall be treated as a transaction [between the partnership and a partner not in its capacity as a partner] or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership. (Emphasis added).

The regulations provide that: Where a contribution and distribution are not simultaneous, the transfers 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.²⁸³ 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. The rationale behind this presumption is that if the partner’s capital has been at risk in the partnership for more than two years, the transfers normally will not be recharacterized as a sale.²⁸⁴ This presumption is rebuttable only if “the facts and circumstances clearly establish that the transfers do not constitute a sale.”²⁸⁵

²⁸² Pub. L. No. 98-69

²⁸³ Treas. Reg. § 1.707-3(b)(1).

²⁸⁴ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

²⁸⁵ Treas. Reg. § 1.707-3(c)(1).

- A. There are a number of issues presented by the disguised sale rules in structuring freeze partnerships where leveraged low basis property is contributed. First, it must be considered whether the payment of a guaranteed payment on the senior interest or a preferred return could be treated as sales proceeds under the disguised sale rules.
- B. In general, the disguised sale regulations do not treat a guaranteed payment for capital as proceeds from a sale of property. The term guaranteed payment for capital means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital.²⁸⁶ (See 707(c)). A payment of money to a partner that is (i) characterized by the parties as a guaranteed payment for capital, (ii) determined without regard to the income of the partnership, and (iii) "reasonable" is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.²⁸⁷
- a. Under the regulations a payment is "reasonable" if (1) the payment is made to a partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and (2) the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.²⁸⁸
- b. A payment is reasonable in amount if the sum of any guaranteed payment for capital (and preferred return) that is payable for that year does not exceed the amount determined by multiplying the partner's unreturned

²⁸⁶ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

²⁸⁷ Treas. Reg. § 1.707-4(a)(1)(ii).

²⁸⁸ Treas. Reg. § 1.707-4(a)(3)(i).

capital at the beginning of the year, or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid guaranteed payment or preferred return that is payable to the partner for any prior year) by the safe harbor interest rate for that year. The safe harbor interest rate equals 150-percent of the highest AFR (applicable federal rate) in effect at any time from the time that the right to the guaranteed payment for capital is first established pursuant to a binding written agreement.²⁸⁹

- C. Of particular concern in structuring a freeze partnership is the treatment of preferred returns under the disguised sale rules. If the preferred return is not considered to be "reasonable" under the disguised sale regulations, the payments could be viewed as part of a disguised sale.
- D. The final regulations define the term "preferred return" to mean a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain. A distribution of money to a partner that is characterized by the parties as a preferred return and that is "reasonable" is presumed not to be part of a sale of property to the partnership.²⁹⁰
 - a. This presumption can only be rebutted by facts and circumstances (including the likelihood and expected timing of the matching allocation of income or gain to support the preferred return) that clearly establishes that the transfer is part of a sale. Whether a preferred return is reasonable

²⁸⁹ Treas. Reg. § 1.707-4(a)(3)(ii).

²⁹⁰ Treas. Reg. § 1.707-4(a)(2).

is determined in the same manner as is a guaranteed payment for capital; thus, the safe harbor rate of 150% of the AFR applies.²⁹¹ Presumably, if the partners agree to a reasonable preferred return that is not expected to be matched with allocations of income until the distant future, the payment of the preferred return may be treated as disguised sale proceeds.

- E. Under the regulations, a distribution of net operating cash flow is presumed not to be part of a sale of property contributed to the partnership. Transfers of money by a partnership to a partner during a taxable year will constitute operating cash flow distributions to the extent that (1) such distributions are not presumed to be guaranteed payments for capital, (2) such distributions are not reasonable preferred returns, (3) such distributions are not characterized by the parties as distributions to the recipient partner acting in a capacity other than as a partner, and (4) such distributions do not exceed the product of (a) the net cash flow of the partnership from operations for the year multiplied by (b) the lesser of the partner's percentage interest in "overall partnership profits" for that year and the partner's percentage interest in "overall partnership profits" for the life of the partnership. This presumption can only be rebutted by facts and circumstances that clearly establish that the distribution is part of a disguised sale transaction.²⁹²
- F. As a safe harbor, in lieu of determining a partner's interest in "overall partnership profits" for a taxable year, the regulations permit the use of the partner's smallest percentage interest under the terms of the partnership agreement in any material

²⁹¹ Treas. Reg. § 1.707-4(a)(3)(ii).

²⁹² Treas. Reg. § 1.707-4(b).

item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year.²⁹³

7. **Impact of Borrowings on Disguised Sale Treatment**

It is possible to affect a disguised sale by borrowing against low basis property and then contributing the encumbered property to the partnership. Economically, this transaction can closely resemble a sale since the contributing partner is at least partially cashed out. In creating a freeze partnership it is essential to be aware that if a refinancing of the contributed property has occurred, the proceeds of the refinancing could be considered disguised sale proceeds. This is especially the case when the refinancing resulted in a cashing out by the contributing partner either within the two years prior to the contribution or within the two years following the contribution. The disguised sale rules do contemplate this scenario and provide that certain types of borrowings will not be considered part of a disguised sale.

One exemption under the disguised sale regulations applies to so called qualified liabilities. Under the regulations, qualified liabilities assumed or taken subject to or in connection with a transfer of property to a partnership generally are not treated as part of a sale. This rule applies to both recourse and nonrecourse loans whether incurred by a partner prior to contribution or by the partnership post-contribution. The two most important factors in determining whether a particular liability is qualified are (i) when it was incurred, and (ii) for what were the proceeds used.²⁹⁴

²⁹³ Treas. Reg. § 1.707-4(b)(2)(ii).

²⁹⁴ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

The regulations contemplate four categories of “qualified liabilities.”²⁹⁵ The first type is a liability incurred by the partner more than 2 years before the contribution of the property to the partnership (or when there was a commitment to make the contribution).²⁹⁶

Second, a liability is qualified if the liability was not incurred in anticipation of the transfer of the property to the partnership but was incurred by the partner within the two-year period prior to the contribution.²⁹⁷ However, there is a presumption that a liability incurred within the two-year period prior to the contribution was incurred in anticipation of the transfer unless the facts and circumstances clearly establish the contrary.²⁹⁸

The third category of qualified liabilities is comprised of liabilities allocable under the interest-tracing rules of Treasury Regulation § 1.163-8T to capital expenditures with respect to the transferred property. Thus, acquisition or improvement debt constitutes a qualified liability.²⁹⁹

Under the fourth category, a liability is a qualified liability if the liability was incurred in the ordinary course of the trade or business in which the property contributed to the partnership was used or held, but only if all of the assets related to the trade or business are transferred, other than assets that are not material to a continuation of the trade or business.³⁰⁰ Under this category there is an additional requirement that the liability cannot exceed the value of the property that secures it.³⁰¹ The rationale for the exemption for liabilities incurred in the ordinary course of business (accounts payable etc.) is that these liabilities are present in essentially all ongoing businesses. If by transferring them the partner was subject to adverse tax

²⁹⁵ Treas. Reg. § 1.707-5(a)(6)(i).

²⁹⁶ Treas. Reg. § 1.707-5(a)(6)(i)(A).

²⁹⁷ Treas. Reg. § 1.707-5(a)(6)(i)(B).

²⁹⁸ Treas. Reg. § 1.707-5(a)(7)(i).

²⁹⁹ Treas. Reg. § 1.707-5(a)(6)(i)(C).

³⁰⁰ Treas. Reg. § 1.707-5(a)(6)(i)(D).

³⁰¹ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

consequences proprietors would opt out of entering into partnerships. Furthermore, this type of liability does not lend itself to “cashing out” one’s investment.³⁰²

The disguised sale regulations also specify rules governing liabilities that are not qualified liabilities which may or may not be treated as part of a disguised sale. In general, these rules provide that in the case of a transfer of property in which the partnership assumes or takes subject to a liability other than a “qualified liability,” the share of the liability shifted to other partners is treated as an amount realized from a disguised sale, regardless of whether the partner receives any cash from the partnership.

Generally, the rules for determining the portion of the liability treated as shifted to other partners depend on whether the liability is recourse or nonrecourse.³⁰³ For liabilities that are recourse, the rules under § 752 and the disguised sale rules are the same.³⁰⁴ The regulations under § 752 provide that a partner’s share of a recourse liability equals that portion of the liability for which such partner (or an affiliate of the partner) bears the economic risk of loss.

However, the disguised sale rules diverge from the § 752 regime in their treatment of nonrecourse liabilities. As discussed below, the regulations under § 752 adopt a three-tiered approach to allocating nonrecourse liabilities. First, nonrecourse liabilities are allocated based upon each partner’s share of partnership minimum gain as determined under the regulations under § 704(b). Second, they are allocated based upon each partner’s share of § 704(c) minimum gain. Last, they are allocated in accordance with a residuary sharing method tied to partnership items that have significant economic effect.

³⁰² Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

³⁰³ See generally Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practising Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).

³⁰⁴ Treas. Reg. § 1.707-5(a)(2)(i).

The disguised sale rules skip the first two tiers of allocations which makes it significantly more difficult to avoid disguised sale treatment for nonqualified liabilities incurred within two years before or after the encumbered property is contributed to the partnership.

If the disguised sale rules adopted a parallel set of rules to the § 752 regime, it would be simple to avoid disguised sale treatment in connection with the contribution of low basis high leveraged real estate to a freeze partnership. Just as the normal operation of the § 752 regulations make it relatively simple to avoid a liability shift upon the contribution of property encumbered by nonrecourse debt, it would also make avoiding a disguised sale relatively simple. However, the disguised sale regulations adopt a different tact.

In lieu of the normal three-tiered approach under the § 752 regulations, under the disguised sale rules, a partner's share of a partnership nonrecourse liability is determined under the third-tier allocation rule alone.³⁰⁵ The third-tier allocation rule provides that a partner's share of the excess nonrecourse liabilities, those not allocated under Treasury Regulation § 1.752-3(a)(1) and (2), are determined in accordance with the partner's share of partnership profits, taking into account all facts and circumstances. Alternatively, excess nonrecourse liabilities may be allocated in accordance with the manner in which deductions attributable to those liabilities will be allocated among the partners.³⁰⁶

To avoid triggering the disguised sale rules, the contributing partner might attempt to utilize a "wraparound contribution." When a contributing partner contributes property encumbered by a liability but the buyer and seller agree that, as between themselves, the seller shall have sole responsibility for the payment of the liability, the liability is not "assumed or

³⁰⁵ See Treas. Reg. § 1.707-5(a)(2)(ii) which incorporates Treas. Reg. § 1.752-3(a)(3) (the third-tier allocation rule).

³⁰⁶ Treas. Reg. § 1.752-3(a)(3).

taken subject to” by the buyer under the installment sale rules.³⁰⁷ Furthermore, the contributing partner who retains the liability may receive a “reasonable” guaranteed payment or preferred return from the partnership to ensure sufficient cash to service the debt.³⁰⁸

8. Leveraged Partnerships: Generally

Recent developments concerning the use of “leveraged partnerships” to avoid disguised sale treatment have a direct bearing on the structuring of a freeze partnership where leverage is employed to reduce the equity that accrues qualified payments. The leveraged partnership techniques are, in economic substance, very similar to a sale but without triggering gain. Where property is transferred to a freeze partnership, but the equity accruing the preferred return is “thinned” by leveraging the partnership, the cash distribution resulting from the leveraging can resemble a sale as well. The cases involving leveraged partnerships may thus be instructive.

A leveraged partnership transaction permits a corporation to effectively sell appreciated property for cash through a partnership interest without immediate tax consequences. The requisite steps to forming and completing a leveraged partnership transaction are as follows: (1) the owner of appreciated assets (“Owner”) contributes the appreciated assets to the partnership while another partner (“Investor”) contributes working capital (or assets) to the newly formed partnership;³⁰⁹ (2) the partnership borrows money from a bank and the Owner personally guarantees the debt of the partnership, making it recourse to Owner; (3) the Owner’s basis in her partnership interest will be increased by the amount of the recourse debt.³¹⁰ If the

³⁰⁷ See *Stonecrest v. Commissioner* 24 T.C. 659 (1955).

³⁰⁸ Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practising Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).

³⁰⁹ Farah N. Homsí, The Leveraged Partnership – Have Your Cake And Eat It Too, *The Practical Tax Lawyer* (Winter 2010), http://www.wolffsamson.com/files/ptxl1002_homsi.pdf

³¹⁰ Id.

Owner's basis was not increased by the debt, the distribution would likely result in a taxable gain to the Owner. (4) The partnership then distributes all or a portion of the loan proceeds to the Owner, which makes the Owner a minority partner by reducing the Owner's partnership interest.³¹¹

A properly structured leveraged partnership transaction can avoid the application of the disguised sales rules making the distribution to Owner of all or a portion of the loan tax-free.

In order to avoid the application of § 704(c)(1)(B) the partnership needs to hold the property for seven years before the original assets can be distributed to the Investor.³¹² The same is true of different assets being distributed to the Owner.³¹³

Under 704(c)(1)(B) if § 704(c) property is distributed to any partner, other than the contributing partner, within seven years of the original contribution, the contributing partner must recognize gain or loss in the amount and character that would have been allocated to her under § 704(c)(1)(A) had the property been sold to the distributee at its fair market value on the date of the distribution.³¹⁴

9. Leveraged Partnership Exception to Disguised Sale

Under regulation 1.707-5(b) there is an additional rule providing an exception from the disguised sales rules for leveraged partnership transactions. The regulation provides that: if a partner contributes unencumbered property to a partnership, the partnership immediately incurs a liability and distributes all or a portion to the contributing partner within 90 days of incurring the liability (determined under § 1.163-8T), then the distribution to the partner

³¹¹ Id.

³¹² I.R.C. § 704(c)(1)(B)

³¹³ Id.

³¹⁴ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 243 (West Publishing 4th ed. 2006)

is taken into account only to the extent that it exceeds the partner's "allocable share" of that liability.³¹⁵

The concept of "allocable share" of liability is crucial in a successful leveraged partnership transaction because the contributing partner's "allocable share" of liability will determine if any of the loan proceeds distributed to her will be deemed a disguised sale.

Under Treas. Reg. § 1.707-5(b)(2) the "allocable share" is determined by multiplying the partner's share of the liability by the following fraction: amount distributed traceable to the liability divided by total amount of the liability.³¹⁶

Treas. Reg. § 1.707-5(a)(2) provides rules for determining the partner's share of liability by determining the partner's share of recourse and nonrecourse liabilities,³¹⁷ and the partner must be allocated enough of the liability to cover the distribution received.

If a partner guarantees a partnership nonrecourse liability to be "allocated" that liability, it is important to ensure that the liability guaranteed by the partner is actually a recourse liability as to that partner.³¹⁸

A recourse liability is defined under Treas. Reg. § 1.752-1(a)(1) as one where, "any partner or related person bears the economic risk of loss for that liability under § 1.752-2."³¹⁹ The constructive liquidation test, set forth in Treas. Reg. § 1.752-2(b)(1), is applied in order to determine who bears the economic risk of loss associated with the recourse liability. The following events are deemed to occur concurrently in a constructive liquidation: (1) all of the partnership's liabilities become payable in full; (2) with the exception of property

³¹⁵ Treas. Reg. § 1.707-5(b); *see also* Treas. Reg. § 1.707-5(f) ex. 10

³¹⁶ Treas. Reg. § 1.707-5(b)(2)(i)

³¹⁷ Treas. Reg. § 1.707-5(a)(2).

³¹⁸ Farah N. Homs, [The Leveraged Partnership – Have Your Cake And Eat It Too](http://www.wolffsamson.com/files/ptxl1002_homs.pdf), *The Practical Tax Lawyer* (Winter 2010), http://www.wolffsamson.com/files/ptxl1002_homs.pdf

³¹⁹ Treas. Reg. § 1.752-1(a)(1).

contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership's assets, including cash, have a value of zero; (3) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (4) all items of income, gain, loss, or deduction are allocated among the partners; and (5) the partnership liquidates.³²⁰

Following the constructive liquidation if, and to the extent that a partner is ultimately responsible for paying a partnership liability, either directly to the creditor, through the partnership, or through the other partners, that partner bears the economic risk of loss.³²¹

10. **Leveraged Partnership Transaction as Applied to Canal Corp. v. Commissioner**

In the past several years the IRS has taken a position that certain leveraged partnership transactions should be tested to determine the transaction's validity under the disguised sales rules.³²² Particularly in 2010 the IRS was successful in challenging Canal Corporation.³²³

In Canal Corp. v. Comm'r Chesapeake's subsidiary WISCO contributed essentially all of its assets to a leveraged partnership created by WISCO and Georgia Pacific. The newly formed Georgia-Pacific Tissue LLC ("LLC") took out a loan and distributed the proceeds to WISCO, and the loan was guaranteed by Georgia Pacific and WISCO agreed to indemnify Georgia Pacific for any principal payments made pursuant to the guaranty.³²⁴ The court held that the leveraged partnership transaction was a disguised sale by WISCO that resulted

³²⁰ Treas. Reg. § 1.752-2(b)(1).

³²¹ Laura E. Cunningham & Noel B. Cunningham, The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships, 120 (West Publishing 4th ed. 2006)

³²² Ruder Ware, Structuring Decisions of Leveraged Partnership Transactions After Canal, Business Transactions Legal Update (May 4, 2011)

³²³ Canal Corp. v. Comm'r 135 T.C. 9 (2010)

³²⁴ Id.

in capital gain includible in Chesapeake's consolidated income for 1999 (when the assets were contributed to the LLC) rather than 2001 (when WISCO sold its LLC interest)³²⁵ because: Georgia Pacific did not require the indemnity; the indemnity agreement did not obligate WISCO to maintain a certain net worth; the structure of the indemnity did not expose Chesapeake's assets to economic risk; the contractual provisions reduced the likelihood of Georgia Pacific invoking the indemnity against WISCO; the indemnity covered only the loan's principal, not interest; Georgia Pacific would first have to proceed against the LLC's assets before demanding indemnification from WISCO if WISCO had to pay the indemnity, WISCO would receive an increased interest in Georgia-Pacific Tissue LLC proportionate to any payment made under the indemnity; a Chesapeake executive represented to Moody's and Standard & Poor's that the only risk associated with the transaction was the tax risk; Chesapeake crafted the indemnity agreement to limit any potential liability to WISCO's assets; WISCO's net worth amounted to only 21 percent of the indemnified LLC liability; WISCO's assets after the transfer to the LLC only included a \$151 million intercompany note between Chesapeake and WISCO and a corporate jet; and the value of WISCO's interest in the LLC would have been zero if the indemnity were exercised because the agreement required Georgia Pacific to exhaust its remedies against the LLC's assets before enforcing the indemnification.³²⁶

Chesapeake sought to apply the 10% net worth requirement from Revenue Procedure 89-12³²⁷ to establish the WISCO was adequately capitalized and that Chesapeake

³²⁵ Mark J. Silverman & Aaron P. Nocjar, Partnership Disguised Sale Rules, Practising Law Institute – Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 90-94 (May 2011).

³²⁶ Terrance Floyd Cuff, *Canal Corporation v. Commissioner*, in 70TH NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, §13.45 (2011).

³²⁷ 1989-1 C.B. 798, *modified by* Rev. Proc. 95-10, 1995-1 C.B. 501, *amplified by* Rev. Proc. 94-46, 1994-2 C.B. 688, *modified by* Rev. Proc. 92-87, 1992-2 C.B. 496, *supplemented by* Rev. Proc. 92-33, 1992-1 C.B. 782, *amplified by* Rev. Proc. 91-13, 1991-1 C.B. 477 ((holding that “a limited partnership would be deemed to lack limited liability for advance ruling purposes if a corporate general partner of the partnership had a net worth equaling 10 percent or more of the total contributions to the partnership”).

would be found to bear the economic risk of loss. However, the court was not persuaded and advised that requirements for advance ruling purposes have no bearing on whether a partner will be treated as bearing the economic risk of loss for a partnership's liability. The Court held that there are no mechanical tests and the anti-abuse rules mandate a consideration of the facts and circumstances. The Court declined to establish a bright-line percentage test to determine whether WISCO bore the economic risk of loss with respect to liability.³²⁸ The Tax Court ultimately found that the indemnity agreement should be disregarded because

[i]t created no more than a remote possibility that WISCO would actually be liable for payment. Chesapeake used the indemnity to create the appearance that WISCO bore the economic risk of loss for the debt when in substance the risk was born by [Georgia Pacific]. We find that WISCO had no economic risk of loss and should not be allocated any part of the debt incurred by [Georgia-Pacific Tissue LLC].³²⁹

The decision in *Canal* is particularly controversial because § 752 contains an assumption that a partner is solvent when applying the economic risk of loss rules. Specifically § 752 provides:

For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.³³⁰

Although WISCO was a subsidiary of Chesapeake the court did not address certain factors related to § 752, such as: that WISCO was not created as part of the plan to limit Chesapeake's liability exposure;³³¹ that WISCO was not a shell corporation set up solely for the

³²⁸ Slip Opinion at 29.

³²⁹ Slip Opinion at 29.

³³⁰ I.R.C. § 752

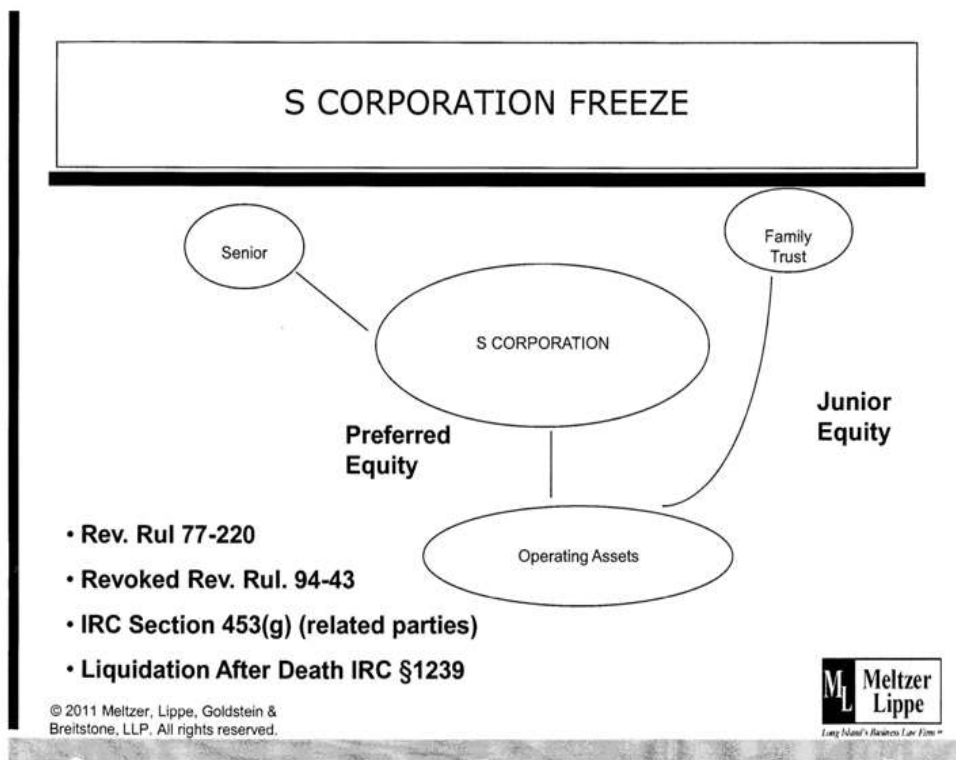
³³¹ Terrance Floyd Cuff, *Canal Corporation v. Commissioner*, in 70TH NEW YORK UNIVERSITY ANNUAL INSTITUTE ON FEDERAL TAXATION, §13.45 (2011).

transaction;³³² that WISCO had substantial capital even though it was considerably less than the amount of the indemnity;³³³ and that the lender in *Canal*, Bank of America, was an unrelated third party which could have enforced the indemnity.³³⁴

The decision in *Canal Corp* has increased the risk of leveraged partnerships however advisors have viewed the outcome as a result of poor planning and structuring rather than a categorical rejection of the technique.³³⁵

FREEZE SPIN OFF TRANSACTIONS

The freeze may also be used to remove appreciation on real estate held by a corporation so that the corporate taxes could be minimized. Over time this technique may eventually result in a phase out of the corporation from the ownership of the real estate. While a phase out will generally not be totally tax free, it can significantly reduce and defer the pain of removing real estate from the corporate solution.



³³² Id.
³³³ Id.
³³⁴ Id.
³³⁵ Id.
<http://bl>

In Cox Enterprises, Inc. v. Commissioner, T.C. Memo. 2009-134, a corporation (“Petitioner”) that was in the newspaper publishing business and also owned and operated cable television and radio broadcasting stations, caused a second-tier wholly owned subsidiary (“KTVU Inc.”) to contribute certain assets of one of its television stations to a newly formed partnership (“KTVU Partnership”). Petitioner was owned 98% by three trusts (the “Shareholder Trusts”) whose income beneficiaries consisted of two individuals (the “Income Beneficiaries”); only after the death of the Income Beneficiaries could income be paid to their issue. In exchange for its contribution of assets, KTVU Inc. took back partnership interests in KTVU Partnership that entitled it to 55% of the profits and liquidation proceeds up to a specified amount, and 75% of profits and liquidation proceeds above such amounts. Two family partnerships (the “FLPs”) that were owned by a combination of the Income Beneficiaries and their issue contributed cash to KTVU Partnership in exchange for the remainder of the profits and liquidation proceeds. The amount of cash contributed by the FLPs was determined by appraisal to be equal to the value of the partnership interests that the FLPs received. Prior to the transaction, Petitioner had attempted to sell KTVU but was unable to find a buyer. It was decided that contributing the television station to KTVU Partnership would benefit Petitioner by reducing its investment in the television business, and would also demonstrate the family’s commitment to that line of business. The IRS did not dispute these business reasons in the court case.

The IRS determined by appraisal that the value of the partnership interest received by KTVU Inc. was \$60 million less than the value of the television assets that it had contributed to KTVU Partnership. For purposes of the summary judgment motion that was the subject of this court case, the Petitioner did not dispute this value. As a result of the foregoing, the IRS argued that because the partners of the FLPs were the same individuals as the beneficiaries of the Shareholder Trusts, the transaction resulted in a constructive dividend from the Petitioner to the

Shareholder Trusts of this \$60 million. The Petitioner filed a motion for summary judgment based on its arguments that (1) the transaction at issue is governed by Code sections 721 and 704(c) and thus Code section 311(b) is not applicable, and (2) because the Shareholder Trusts did not benefit from the transaction, the constructive dividend theory is not applicable.

In an opinion written by Judge Halpern, the Court agreed with the Petitioner and granted the motion for summary judgment. The Court found that the primary purpose of the transaction was not to provide an economic benefit to the FLPs and derivatively to the Shareholder Trusts as the IRS had argued. Instead, unlike the cases finding a constructive dividend, here there was a business purpose for the transaction. In addition, the parties attempted to structure the transaction in an arms' length manner. This was evident by the fact that the parties obtained an appraisal to try to determine the proper amount of cash that the FLPs had to contribute for their interest in the KTVU Partnership. In addition, the trustees of the Shareholder Trusts who agreed to this transaction were bound by fiduciary duties. Finally, although the remainder beneficiaries of the Shareholder Trusts did benefit from the transaction in that they now had immediate access to income from KTVU through the FLPs, the Shareholder Trusts themselves did not benefit from the transaction. *See* also PLR 9427023. Where the Service found Section 2701 inapplicable, when taking into account ownership through a grantor trust a corporation contributed business assets to a partnership between the corporation and the shareholders.

CONCLUSION

Estate and transfer tax planning for the long term real estate owner is a multidisciplinary process. It is necessary to develop and appropriate set of entity agreements that accomplish the needs of the business for succession planning and that also maximize valuation opportunities for estate, gift and transfer tax planning. However, it is also necessary to give

special attention to the income tax concerns that are central to real estate ownership. One such concern is to maximize the basis step up upon death under section 1014 of the Code. Frequently used estate planning techniques may not work well for this purpose since they involve transfers to grantor trusts. The freeze partnership or limited liability company under section 2701 may be an optimal technique to not only freeze values that will be subject to estate, gift and generation skipping taxation, but it may also maximize the basis step up upon death – including that attributable to negative capital.