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

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Don’t forget the income tax side

Basis step up v. transfer tax savings

- Different Tax Base (Federal)
  - Estate Tax 40% Net Equity
  - Income Tax 20-39.6% of Gain

    Amount realized includes nonrecourse debt

Lifetime planning can sacrifice basis step up to save estate and gift taxes – may not be a good tradeoff.

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

Comparison of Freeze Techniques

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

Freeze Techniques (cont.)

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

Freeze Techniques (cont.)

- Installment Sales to IDGTs:
  - Lowest rate (AFR)(Sept 2013, ST .25%; MT 1.64%; LT 3.23%)
  - Difficulties with valuation
    - But courts are becoming receptive to valuation clauses
  - Risky if property depreciates
  - Can maximize leverage and allocated GST exemption to initial gift (if there is one)
  - Note included in estate will not qualify for 6166 deferral
  - Most likely to result in NYC and NYS transfer taxes
  - Termination of Grantor trust status income tax
    - May result in gain recognition
    - Basis step up upon death uncertain

Freeze Techniques (cont.)

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

Elements of the Freeze Partnership

- There are typically two classes of partnership interest:
  - Preferred interest, which is entitled to a preferred return and a liquidation preference (like preferred stock).
  - Junior equity interest, which is entitled to growth and appreciation (like common stock).

(a) The preferred interest is typically retained, and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer.

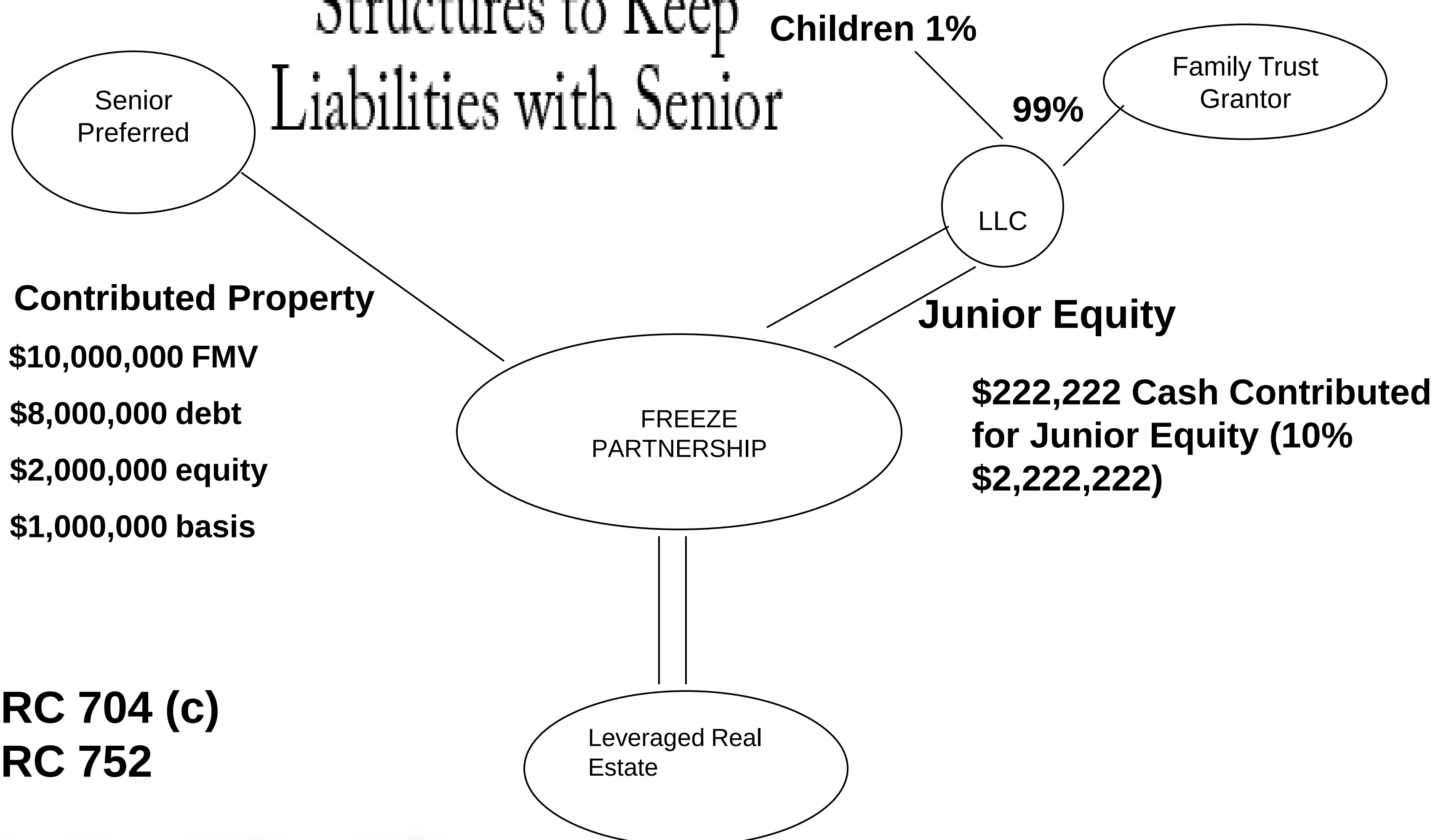
Liabilities in Excess of Basis (a/k/a Negative Capital)

What is this Negative Capital?

Is it logical?

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

Structures to Keep Liabilities with Senior



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How the Assets Contributed to the Freeze Partnership Are Valued

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Typical Assets That Need to be Valued

- Real Estate
- Marketable securities (liquid and illiquid)
- LLC interests
- Privately held businesses

Standard of Value the IRS Requires

- Fair Market Value -

  The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of all relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Valuation Approaches

- Income Approach
- Asset Approach
- Market Approach

Discounts for Lack of Control

- RELP's
- Investment Discounts
- Minority Cash flows
- Mergerstat

Discounts for Lack of Marketability

- Studies
- Modeling

Determining the Preferred Rate of Return

- Proxy: dividend yields on preferred securities in the applicable industry
- Estate of Trompeter v Commissioner *T.C. Memo 2004-27*
  - Yield must include a factor for the time value of money
- Revenue Ruling 83-120 outlines three criteria for the valuation of preferred stocks
  - Yield
  - Dividend coverage ratio
  - Protection of its liquidation preference
  - Apparently lesser, but not immaterial, weight to voting rights (e.g. voting control) and lack of marketability
  - Current market conditions
  - Underlying risk profile of the PLP assets and preferred rate coverage
    - (a) Volatility
    - (b) Income production (actual or through unitrust contributions
- Marketability issues are consumed in the yield
- Future planning opportunities dictated by yields

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Approaches to Calculating Marketability Discounts

Ashok Abbott

We Are in Transition

- There is a move away from studies to more empirical analysis

- Marketability discounts v Liquidity discounts

Non Modeling Techniques Utilized in the Past and Today

- Historical discounts
- Benchmarking
- Restricted Stock Studies
- Re IPO Studies
- Their weaknesses

Modeling Techniques Currently Accepted

- The advantages do they have over the non modeling techniques
- The popular modeling techniques
- The tendencies of each
- They can be explained so they are understandable to a judge or jury and can stand up to cross or the IRS- they are aware of them
- Pitfalls
- Potential for overlap with the size premium