



# ESTATE PLANNING FOR REAL ESTATE

*2007 AICPA NATIONAL REAL ESTATE CONFERENCE*

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**STEPHEN L. OWEN** practices in the Washington, D.C., and Baltimore, Maryland offices of DLA Piper US LLP where he serves as Chair of the Tax Practice Group. He practices primarily in the areas of mergers and acquisitions, joint ventures, business transactions, corporate and partnership tax planning, real estate tax planning, and business and estate planning for closely-held enterprises and their owners. Mr. Owen represents a variety of publicly-traded corporations and REITs, as well as many successful privately-owned businesses and entrepreneurs. Mr. Owen has written on a variety of tax and business topics, including extensive works on corporate, partnership and real estate taxation, and estate planning in various professional journals. He is a member of the editorial boards of *The Journal of Real Estate Taxation*, *The Journal of Pass-Through Entities* and *The Practical Tax Lawyer*. He is a frequent speaker on tax and business topics at nationally recognized programs including The N.Y.U. Institute on Federal Taxation, The Southern Federal Tax Institute, N.Y.U. Real Estate Tax Institute, The Federal Real Estate Tax Conference, The New Jersey Tax Institute, The North Carolina Tax Institute, The Tennessee Tax Institute, The Kentucky Tax Institute, The National Association of Real Estate Companies Tax Conference, The William & Mary Tax Conference and The Texas Tax Institute. Mr. Owen is a past Chair of the Partnerships and LLCs Committee of the ABA Section of Taxation and is a past Chair of the Section of Taxation of the Maryland State Bar Association. Mr. Owen is listed in *The Best Lawyers In America* in the categories of tax law and corporate law and in *Who's Who Legal: USA Corporate Tax 2006*. He is also a Fellow of The American College of Tax Counsel and is an active member of Real Estate Roundtable and NAREIT. Mr. Owen is a member of the Board of the Maryland Zoo in Baltimore and the Caves Valley Caddie Scholarship Foundation.

# THE FACTS

A. Senior, age 85, has been actively involved in the real estate business for many years. Senior owns all of the stock of HotelCorp, an S corporation that owns several successful hotels. HotelCorp was a C corporation until 2001 when Senior finally listened to his CPA, Mr. Fudge, and made an S election for HotelCorp. The value of HotelCorp at the time of the S election was \$10 million, based upon the independent appraisal of Mr. Lowball. HotelCorp is now worth about \$50 million. HotelCorp has no debt and generates \$5 million of cash flow per year.

B. Senior owns a 1% GP interest and a 98% LP interest in Office LP with a 1% LP interest held by Senior's son, Junior. Office LP owns several office buildings that were purchased many years ago. Office LP has substantial nonrecourse debt and Senior's capital account is negative \$10 million. The gross value of the office buildings is \$50 million and the aggregate basis is \$20 million with the debt totaling \$30 million.

C. Senior also owns 100% of the interests in three LLCs that own apartment complexes that were recently acquired. These LLCs have no debt because Senior purchased the complexes using his personal capital. Each of the apartment complexes has an adjusted basis of \$7 million and a value, according to Lowball, of \$10 million.

D. Senior is planning to purchase a large tract of land which he would like to develop into a mixed use complex. Senior also has \$20 million in marketable securities and a beach house.

E. Senior is twice divorced and is now dating Nancy, age 30. Nancy was Senior's nurse after his third heart attack in 2005. Junior, age 60, is Senior's only child. Junior has worked with Senior in the real estate business for 35 years, although Junior can usually be found on the golf course most afternoons (at least until cocktail hour). Junior has 3 children, none of whom is expected to work in the business.

F. Senior is a workaholic but he is planning to slow down once he marries Nancy next month (Nancy has refused to sign a pre-nup). Encouraged by Nancy to "smell the roses," Senior has recently found inner peace through skydiving.

G. Based upon advice from Fudge and his attorney, Shark, Esquire, Senior has decided to transfer some equity in the businesses to Junior. However, Senior would like to retain control because he does not believe Junior is yet mature enough to take over the reins of the business.

# VALUATION OF BUSINESS INTERESTS

The estate tax, the gift tax and the generation skipping tax are imposed on the value of assets. Valuation of stock in an S corporation or interests in a partnership or LLC is determined based upon the “willing buyer/willing seller” standard.

Reg. §20.2031-1(b).

## Exceptions:

- Applicable Exclusion Amount (Estate Tax and GST) - \$2 million.
- Gift Tax Exclusion - \$1 million
- Annual Gift Tax Exclusion - \$12,000 per donee
- Medical and Tuition Expense Gift Tax Exclusion
- Marital Deduction
- Charitable Deduction

# BASIS RULES

- Lifetime Gift – Carryover basis (§1015(a))
- Death – Stepped up basis (§1014)
- Sales – Stepped up (cost) basis (§1012)
- Partnerships- Section 754 Elections;  
743(b): “Inside Basis” Step Up

NOTE: Proposed legislation would offer only limited step up in basis at death. This could really hurt real estate entrepreneurs who have large negative capital accounts.

# VALUATION DISCOUNTS

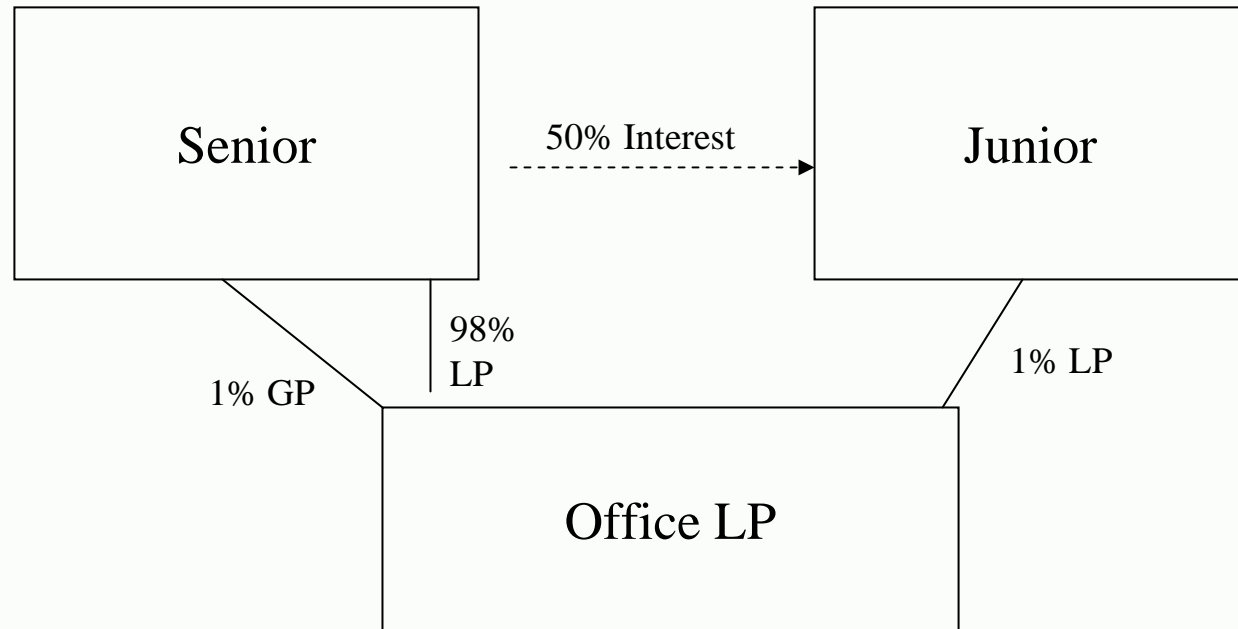
- Tenancies In Common – IRS takes the position that an undivided interest should be discounted only for the costs of partitioning (say, 10%) . However, the courts have been more generous. See, e.g., LeFrak v. Com'r, 66 TCM 1297 (1993) (30% discount); Williams v. Com'r, 75 TCM 1758 (1998) (44% discount).
- Minority Interest Discount – Reflects the reduced value of a business interest that does not have control of the entity. The interest does not control sales, distributions or dissolution.
- Lack of Marketability Discount – Reflects the limited ability of the owner of a business interest to sell the interest to a third party.
- Blockage Discount – reflects the fact that, if properties were put on the market at the same time, the market value would be depressed. In the real estate context, see, e.g., Estate of Rogers v. Com'r, 77 TCM 1831 (1999).

- Portfolio Discount – Reflects the fact that a purchaser of a business interest may not pay full value if the entity owns a variety of unrelated assets. For example, a partnership that owns a ranch, a hotel and an office building. See, e.g., P. M. Adams, 2001-2 USTC ¶ 60, 418.
- “Tax Affecting” Discount –Applied in the case of an S corporation or partnership to reduce the earnings of the entity to make comparable to a C corporation. Gross v. Com’r, 272 F.3d 333 (6<sup>th</sup> Cir. 2001) (rejected).
- “Swing Vote” Premium – The Service has argued that a minority interest should not be discounted if, when combined with another ownership block, it may have the ability to control certain votes.
- Unrealized Capital Gain. When an entity is valued on a liquidation approach, the inchoate tax liability that would result from the sale of assets. E.g., Estate of Dunn v. Com’r, 301 F.3d 339 (5<sup>th</sup> Cir. 2002).

## VALUATION: THE FOUNDATION

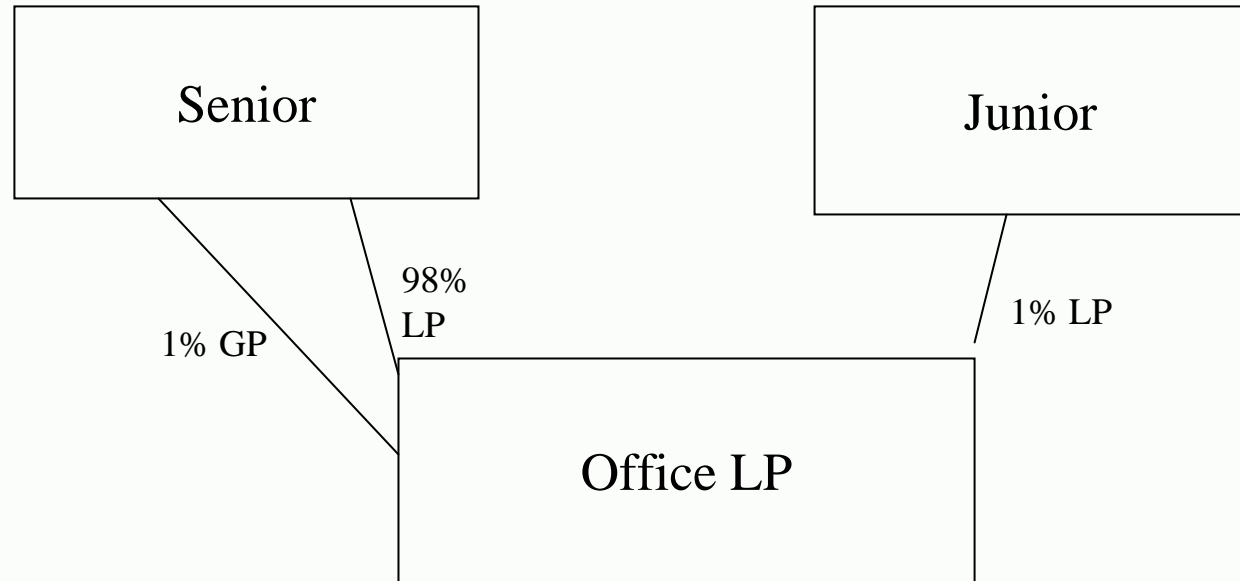
- Rev. Rul 93-12, 1993-1 C.B. 202, is the foundation for valuation of business interests for tax purposes. The Service concedes that there are no family (or other) attribution rules in valuing a business interest.
- For gift tax purposes, the business interest being transferred is valued on a “stand alone” basis. It does not matter what the donor retains after the gift nor what the donee already owns.
- For estate tax purposes, the value of the combined business interests owned by the decedent is the focus.

# REV. RUL. 93-12



- Senior makes a gift of a 50% LP interest in Office LP. The question is what a willing buyer would pay for a 50% LP interest in Office LP. It is irrelevant that Junior is Senior's son. It is irrelevant that Senior retains control. It is irrelevant that Junior already owns an LP interest.
- Carryover basis for gifted interest.
- Part sale/part gift for negative capital account.
- Note if Junior were the GP before the gift, irrelevant in valuing gifted interest.

## REV. RUL. 93-12 (continued)

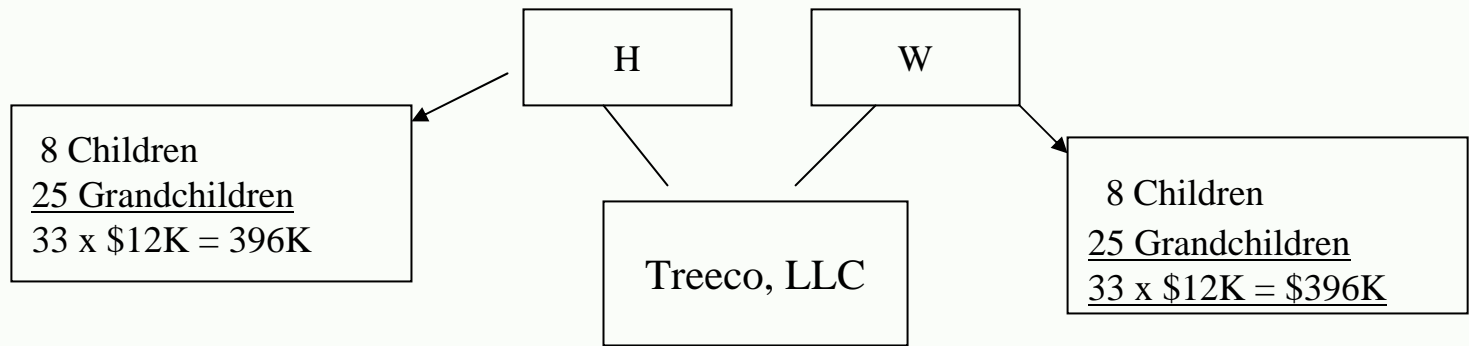


- If Senior dies owning a 98% nonvoting limited partnership interest, there would be no discount because Senior also holds the 1% general partner interest.
- Full basis step up.
- 754 election.

# DEPRESSING AND SHIFTING VALUE

- Discounting – Separating Voting Control from Equity Value  
- Dividing ownership of Voting Rights.
- Gifts of Equity Interests – Shifts current value; shifts future appreciation; hard to hit a “Home Run”; Carryover Basis.
- Installment Sales of Equity Interests – Freezes value; shifts current value to extent of discounts; shifts future appreciation; triggers income tax; Stepped up Basis.
- Sales of Equity Interests For Private Annuity – Freezes value; shifts current value to the extent of discounts; shifts future appreciation; triggers income tax; value “evaporates” in right circumstances early death; Stepped up Basis.
- Grantor Retained Annuity Trusts (“GRATs”) – Freezes value; shifts current value to the extent of discounts; shifts future appreciation; Carryover Basis.
- Installment Sales to Defective Grantor Trusts (“IDGTs”) – Freezes value; shifts current value to the extent of discounts; shifts future appreciation; Carryover Basis.

# Annual Exclusion Gifts

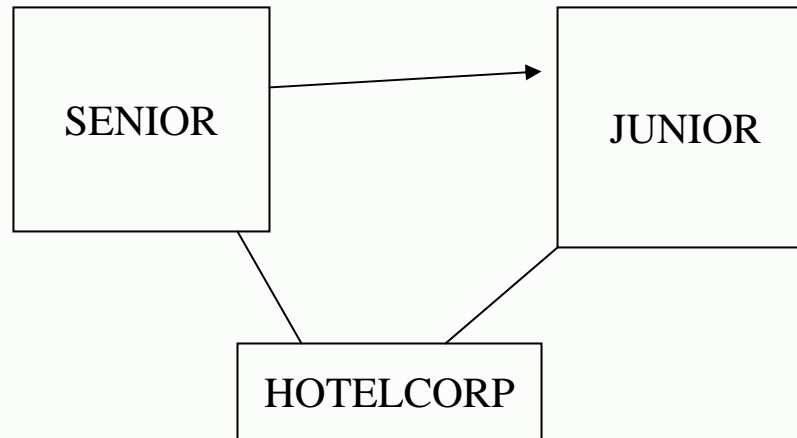


- Treeco, LLC is a limited liability company formed to own and operate a tree farm. At the time of formation, it was anticipated that the Treeco operations would produce a loss for the foreseeable future and that there would not be any cash distributions in the near term. Long-term growth was the objective.
- The operating agreement provides that:
  - H is Manager.
  - H, as Manager, will act in good faith and in the best interests of the company.
  - H, as Manager, may direct that cash be distributed pro rata.
  - The members have no right of partition.
  - Members cannot withdraw initial contributions or demand property.
  - Members cannot withdraw without the consent of H, as Manager.
  - Any member desiring to withdraw may offer his units for sale to the company, “in the person of the Manager,” who has the exclusive authority to negotiate.
  - No transfers without the consent of the Manager (although, there is an acknowledgment that a non-permitted transferee would be entitled to receive the profits and distributions which otherwise would have inured to the transferor).
- On the facts, can H and W use the Treeco, LLC units to accomplish “annual exclusion” gifts?

## ANNUAL EXCLUSION GIFTS

- §2503(b) excludes from taxable gifts the first \$12,000 of gifts made during the calendar year to a donee, other than gifts of future interests in property. Treas. Reg. §25.2503-3 provides that an unrestricted right to the immediate use, possession or enjoyment of property or the income from property is a “present interest” in property.
- In *Hackl*, 118 T.C. 279 (2002), the Tax Court (Judge Nims) concluded that the gifts of limited liability company interests made by a husband and wife, on facts similar to those provided in the example, do not qualify as gifts of “present interests” because of the restrictions on the right to compel distributions and restrictions on transfer.
- The taxpayers argued that the gifted limited liability company interests were not subject to restrictions and that the donees acquired all rights in and to the gifted interests which were identical to the interests retained by the donor. The gifts involved no postponement of rights, powers or privileges that would cause the gifts to constitute future interests. When a gift takes the form of an outright transfer of an equity interest, no further analysis is required.
- Compare Ltr. Rul. 9131006 (April 30, 1991); Ltr. Rul. 9751003 (Aug. 28, 1997); Ltr. Rul. 199905010 (Oct. 30, 1998). Generally, annual exclusions of limited partnership interests are allowed where transfers are subject to rights of first refusal.

# S CORPORATION DISCOUNTING



- Suppose that Senior wishes to gift stock to Junior.
- Senior transfers nonvoting stock to Junior, either as an outright gift or as a transfer to a GRAT or as an installment sale to a defective grantor trust (“IDGT”), or some combination. Senior retains control with the retention of the voting common.
- Senior, relying on an independent valuation expert, takes a 40% discount from NAV on the transfers. Part of the discount is attributable to the potential BIG tax. See A.D. Davis Est., 110 T.C. 530 (1998); Eisenberg v. Com’r, 155 F.3d 50 (2<sup>nd</sup> Cir 1998 ); Estate of Dunn v. Com’r, 301 F.3d 339 (5<sup>th</sup> Cir 2002); Estate of Jameson v. Com’r, 777 CM 1383 (1999), rev’d, 267 F.3d 366 (5<sup>th</sup> Cir 2002). See also W.L. Gross 78 TCM 201 (1999) (whether S corporation earnings can be “tax affected”).

# S CORPORATION DISCOUNTING

- Discounting for lack of marketability and minority interest is available just as in the case of limited partnership and LLC interests.
- Note that, unlike in the partnership context after Strangi II, there should be no attack under Section 2036(a)(2). See Rev. Rul. 81-15, 1981-1 C.B. 457. As long as the corporate formalities are observed, Section 2036(a) should not apply.
- Note that S corporations have negative features compared to partnerships and LLCs taxed as partnerships, such as (i) limitations on stockholder basis for corporate debt, (ii) deemed taxable sale on distribution of appreciated assets, and (iii) limited permitted stockholders, etc.

# CHAPTER 14

- Chapter 14 of the Internal Revenue Code (§§2701-2704) provides special valuation rules for family business interests.
- 2701 - Applies special valuation rules for certain “applicable retained interests” in family entities. Does not apply to “straight up” deals.
  - A distribution right (such as noncumulative preferred distributions) is valued at zero. A distribution right that is a “qualified payment” (fixed cumulative preferred distributions payable within four year grace period) is valued using customary valuation rules. Only applies to preferred distributions.
  - Liquidation, put or call right is valued at zero unless it must be exercised at a specific time at a specific amount.
  - Junior equity interests must have a minimum value of 10% of total equity plus debt held by family members.
  - 2701 must be dealt with in the “partnership freeze” context.
- 2702 – Provides statutory rules for GRATs

- 2703- Value of property is determined without regard to:
  - Any option, agreement or other right to acquire or use property at a price less than fair market value, or
  - Any restriction on the right to sell or use such property
  - Exception (all must be satisfied):
    - Bona fide business arrangement
    - Not a device to transfer property for less than full consideration
    - Terms are comparable to arm's length transaction
- 2704(a) – Lapse of voting or liquidation rights may be treated as a transfer of property subject to estate or gift tax. As a practical matter should be easy to avoid.
- 2704(b) – Requires that a business interest be valued without regard to “applicable restrictions”.
  - “Applicable Restriction” is a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the “default” restriction under state law.
  - Many state partnership and LLC statutes have been amended to restrict the ability of a partner/member to withdraw and receive any distributions. Prior laws typically permitted partners to withdraw on six months notice and receive “fair value” (note even this did not necessarily mean “full value”).
  - See Kerr v. Com’r, 113 TC 449 (1999).

## NON-TAX PURPOSES FOR FLP

- Asset Protection. Creditors of a partner/member may obtain “charging order” against the partner/member so creditor receives distributions otherwise made to partner/member. Creditor must sit and wait; it cannot force distributions by entity. But see In Re Albright, 291 B.R. 538 (Bnkr D. Col. 2003) (single member LLC and dicta).
- Note: Having trust as partners/members may offer even more asset protection.
- Assignee Rights. Agreement can restrict rights of creditor by only giving rights as assignee.
- Separate Management Rights From Economic Rights. Protect management rights from creditors.
- Consolidation of Assets. Creates economics of scale. Management efficiencies.
- Ease of transferring interests; potential avoidance of state transfer taxes.

# IRS ATTACKS ON FLPs

- “Sham” Transaction. See e.g., the “Sham TAMs” (TAM 199719006; TAM 199723009; TAM 199736004). Could be applied where FLP separateness and formalities not respected. Commingling of assets.
- “Step” Transaction. Could be applied where formation of FLP and gifts occur simultaneously and contribution mechanics not respected.
- Gift on Formation of FLP. Weak argument for IRS if capital accounts are respected (“liquidation theory”). “Disappearing value” does not equal gift.
- Section 2703 – disregard the FLP in toto. Courts have rejected this sweeping application of 2703.
- Section 2703 – disregard restrictions on transfer and liquidation. Courts have rejected.
- Section 2704(b) – disregard “applicable restrictions”. This argument is not accepted by courts where state law “default rule” restricts ability to withdraw and receive “fair value.”

# RETAINED INTERESTS IN TRANSFERRED PROPERTY

- Sections 2036 (and 2038)
- If a donor transfers property during life but retains “strings” over the property, the property can be included in the donor’s estate.
  - Section 2036(a) – donor either (1) had possession or enjoyment of, or the right to income from, the transferred property, or (2) had the right, either alone or in conjunction with another, to designate the persons who will possess or enjoy the transferred property or the income therefrom.
- Exception: Transfers where a “bona fide sale” for “adequate and full consideration” in money or money’s worth.

# STRANGI I

- FLP formed two months before death of Senior pursuant to a power of attorney granted Senior's son-in-law.
- Senior transferred 98% of his assets to FLP including his residence (no rent paid until three years after death).
- 1% corporate GP was owned 47% by Senior, 13% by four children and 1% by a public charity.
- FLP paid personal expenses of Senior including nurse.
- Distributions were at times disproportionately made to Senior.
- Management agreement authorized son-in-law to manage assets of FLP – same assets son-in-law had managed prior to FLP.
- In Strangi I, Tax Court rejected Service's attacks on discounting. Section 2036 argument was raised too late. Fifth Circuit remanded to Tax Court to consider 2036 argument.

# STRANGI II

- IRS prevails on 2036 arguments.
- 2036(a)(1) – inclusion of partnership assets under the “right to income” rule. Document did not restrict ability of Senior (acting through son-in-law) to be designated as the recipient of FLP distributions (but Strangi I found valid partnership and it provided for pro rata distributions). In addition, Tax Court found retained “possession or enjoyment”:
  - Senior retained same relationship to FLP assets as he had prior to formation. Mere “Recycling of Value.”
  - Assets not contributed to FLP were insufficient to cover Senior’s needs.
  - FLP made distributions to cover Senior’s living expenses.
- 2036(a)(2) – Tax Court concludes Senior, together with his family members, had the right to designate who will “enjoy” the FLP property or the “income therefrom”. Ignores Byrum, 408 U.S. 125 (1972) (transfer of voting stock to trusts with retained voting rights in transferred stock - - no estate inclusion because of fiduciary duties under corporate law).

## 2036(a)

### BAD FACTS MAKE BAD LAW

- Strangi v. Com'r, 115 T.C. 478 (2000), aff'd and remanded, 293 F.3d 279 (5<sup>th</sup> Cir 2002) (“Strangi I”).
- Estate of Strangi v. Com'r, 85 TCM 1331 (2003), aff'd 417 F.3d 468 (5<sup>th</sup> Cir 2005) (“Strangi II”).
- Estate of Reichardt v. Com'r, 114 TC 144 (2000).
- Estate of Schauerhamer v. Com'r, 73 TCM 2855 (1997).
- Estate of Harper v. Com'r, 83 TCM 1641 (2002).
- Estate of Thompson v. Com'r, 84 TCM 374 (2002); aff'd 382 F.3d 367 (3d Cir 2004).
- Estate of Abraham v. Com'r, 87 TCM 975 (2004), aff'd, 408 F.3d 26 (1<sup>st</sup> Cir 2005).
- Estate of Korby v. Com'r, 471 F.3d 848 (8<sup>th</sup> Cir 2006).
- Estate of Bigelow v. Com'r, TCM 2005-65 (2005), aff'd, 2007-2 USTC ¶60, 548 (9<sup>th</sup> Cir 2007).
- Estate of Erickson v. Com'r, TCM 2007-107 (2007).
- Estate of Rosen v. Com'r, TCM 2006-115 (2006).
- Estate of Bongard v. Com'r, 124 TC 95 (2005).

## BONA FIDE SALE EXCEPTION TO 2036(a)

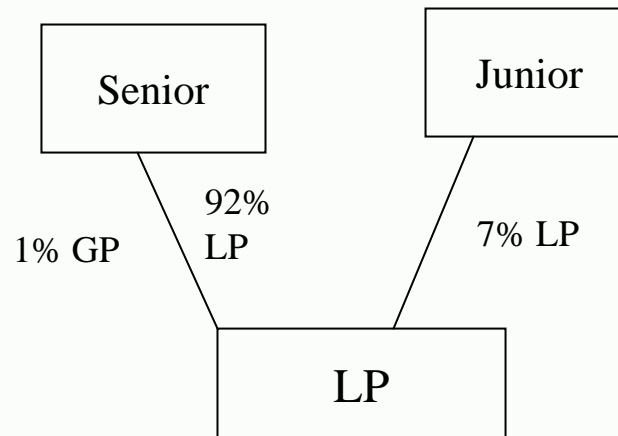
- Tax Court has stated that the 2036(a) exception is met in FLP context where the facts establish existence of a legitimate and significant nontax reason for creating the FLP and that the transferors received partnership interests proportionate to the value of the contributed property. Estate of Bongard v. Com'r, 124 TC 95 (2005).
- Kimbell v. Com'r, 371 F.3d 257 (5<sup>th</sup> Cir 2004) – 2036(a) exception applied where 96 year old formed FLP two months before death. Bona fide business purposes – asset protection; and coordinate management of oil and gas properties.
- Estate of Stone v. Com'r, 86 TCM 551 (2003) – another favorable case.

# MINIMIZE RISK OF FLP ATTACK

- Do not transfer substantially all of Senior's assets to FLP. Senior needs retained assets for comfortable living.
- Do not transfer personal assets to FLP.
- Make sure all contributed assets are properly retitled in name of FLP.
- Maintain separate books and records for FLP. Do not commingle funds. Do not make disproportionate distributions. Do not pay personal expenses from FLP.
- Consider having younger generation make substantial capital contributions ("pooling of interests").
- Avoid having Senior retain control of FLP.
  - Use trusts with independent trustees.
  - Have mature younger generation control.
  - Use corporate GP where Senior and spouse each own, say, 26% and trust for children own balance. First to die isolates the 26% in separate trust
- Have nontax business purposes for FLP
- File all tax returns in a timely manner
- Obtain well reasoned appraisal of business interests

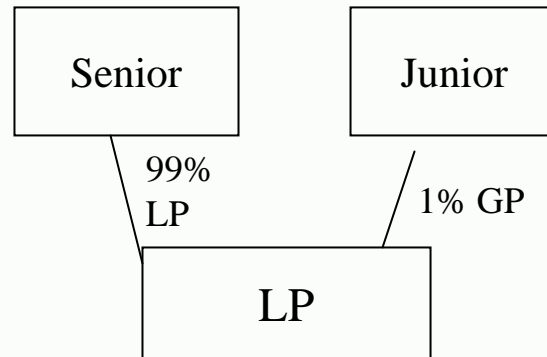
# THE FAMILY LIMITED PARTNERSHIP

- Senior decides to form an FLP with Junior. Senior will contribute his single member LLCs to the FLP in exchange for a 1% GP interest and a 98% LP interest. Junior will contribute cash for a 1% LP interest.
  - Note that if Senior dies at this point, his 98% LP interest would not be discounted because Senior is the GP.
- Senior gifts to Junior a 6% LP interest worth \$990,000 after applying a 40% discount. Senior dies two years later. Does Senior's retention of the GP interest cause a problem in excluding from his estate the gifted LP interests?



# THE FAMILY LIMITED PARTNERSHIP

- Senior is told by his advisors that it would be better tax planning to have Senior receive only an LP interest in LP and that Junior should receive the 1% GP interest on formation of the LP.



- Note if Senior dies at this point, his 99% LP interest should be eligible for a discount.
- Risk of including gifted interests in estate under 2036 is minimized.
- Problem: Junior is an idiot.
- What if Senior gives Nancy the 1% GP interest? **BE PRACTICAL!**
- What if Senior forms a trust with Shark as trustee and Senior transfers the 1% GP interest to the trust with Junior as the beneficiary.
- Note if Senior dies at this point, his 99% LP interest should be eligible for a discount.
- Risk of including gifted interests in estate under 2036 is minimized.

# THE FAMILY LIMITED PARTNERSHIP

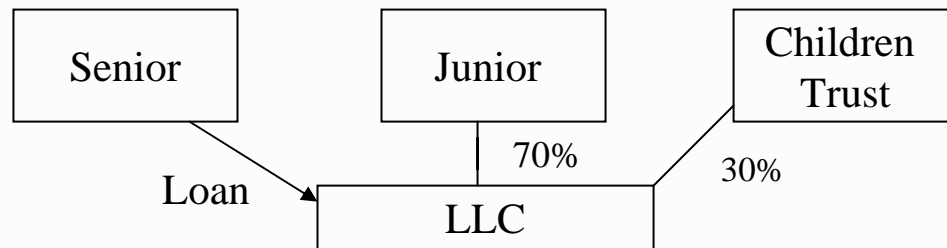
- Senior hates the idea of paying estate taxes. Senior also hates Nancy and decides not to get married. Senior will put all of his assets into an FLP, including his marketable securities, his beach house and even his primary residence. Senior will only be an LP with the Shark Trust being the GP.
- Shark will pay Senior's bills and living expenses from FLP.
- Beware bad facts.
- Respect separateness of FLP.

# THE FAMILY LIMITED PARTNERSHIP

- Prior to forming the FLP, Senior is told he has terminal cancer. At the suggestion of Shark, Senior proceeds to form the FLP by contributing his interests in the Apartment LLCs, the undeveloped real estate and his 99% interest in Office LP in exchange for a 99% LP interest in FLP. Junior contributes cash for a 1% GP interest. The papers are signed on December 20.
- Senior dies of a heart attack in mid air while skydiving on December 22. The Certificate of Limited Partnership is filed with the State on December 28. The deed for the undeveloped real estate is not recorded until January 1 of the following year.
- Lowball values Senior's 99% LP interest using a 40% discount. Is there a concern that the discount will be respected?
- See E. J. Church v. Com'r, 268 F.3d 1063 (5<sup>th</sup> Cir. 2001). (58% discount accepted – government failed to offer valuation expert).

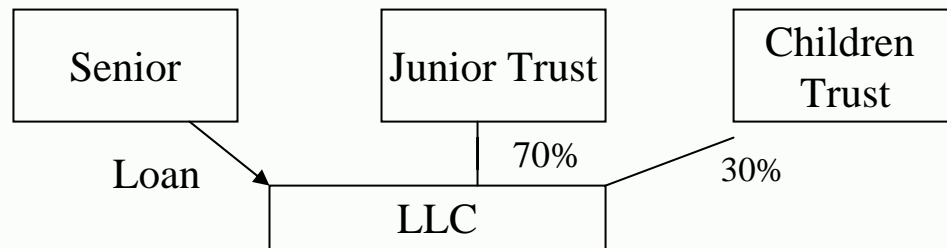
## STRUCTURING NEW DEALS

- Senior wants to purchase and develop a new tract of land that has significant appreciation potential. Senior is willing to let Junior have “legal” control of the deal.
- The new property will cost \$3 million.
- Senior tells Junior to form an LLC. Junior will own 70% of the interests in exchange for \$700. A trust for the benefit of Junior’s children will own 30% in exchange for \$300.
- Senior lends the LLC \$3 million. The loan is on arm’s length terms and is secured by the property. Chapter 14 does not apply.



# STRUCTURING NEW DEALS

- What if Senior does not want Junior to control the new deal?
- Senior could form a trust for the benefit of Junior. Senior makes a \$700 gift to the trust. The trustee is Shark.

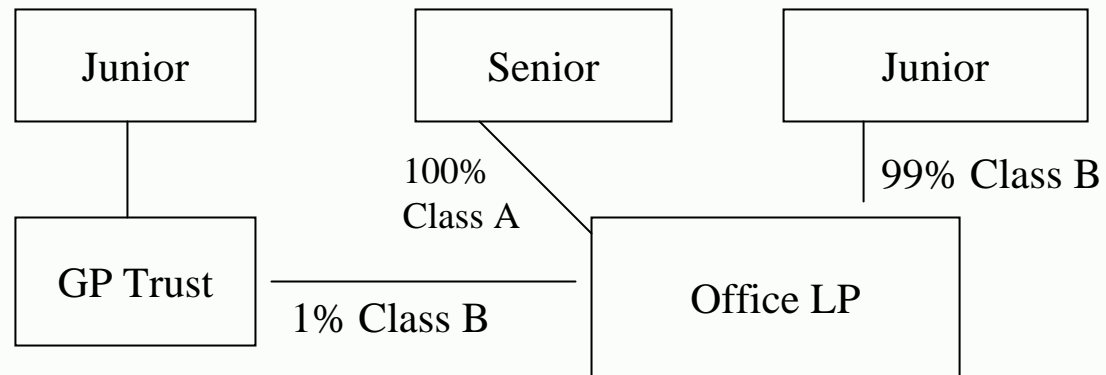


# INCOME TAX ISSUES

- 721(b) – “Investment Company” Trap. Usually Not a Problem with Real Estate.
- 704(c) – Tracking of Built In Gain on Contributed Assets
- 752 – Liability Sharing
- 704(c) and 737 – Contributions/Distributions within 7 years.
- 701 Anti Abuse Regs – Not Applicable to Estate and Gift Taxes.

# THE FREEZE PARTNERSHIP

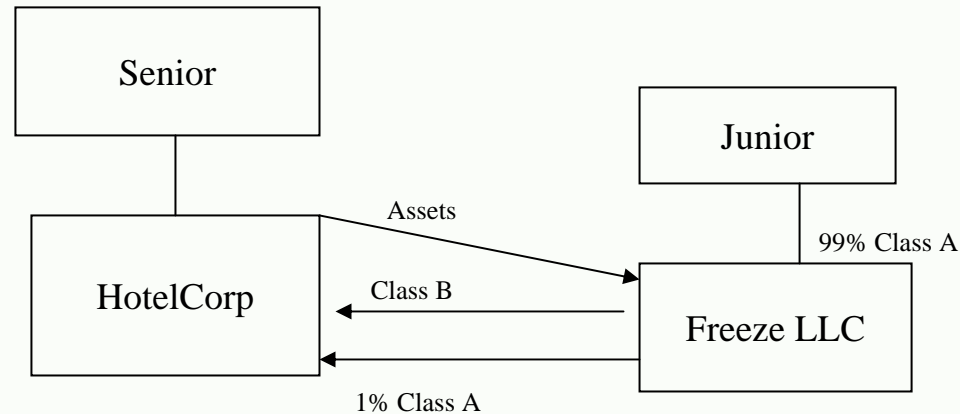
- The vanilla FLP provides for “straight up” sharing of economics. Where partnership interests are being gifted and negative capital accounts exist that are attributable to nonrecourse debt, this could trigger gain to donor.



- Senior and Junior form Office LP. Senior creates GP Trust with cash contribution. GP Trust, Shark as trustee, contributes cash for a 1% Class B interest. Junior contributes cash for a 99% Class B interest.
- Senior contributes \$50 million of assets subject to \$30 million of nonrecourse debt in exchange for 100% Class A interest.

- The Class A interest entitles the holder to a preference on liquidation sales or refinancings of \$20 million and a cumulative annual distribution from cash flow of \$2 million. Any remaining distributions after these preferences go 5% to Class A holders and 95% to Class B holders.
- Keypoint: After applying the special valuation rules of Section 2701, make sure value of Class A interest is equal to the contributed assets value. The annual cumulative distributions would be a “qualified payment” under 2701 (must be paid within four years).
- Keypoint: Nonrecourse debt can be retained by Senior because of minimum gain and 704(c) built in gain.
- Use traditional method under 704(c) allocation rules.
- Future increases in cash flow and appreciation are shifted to Junior.

# THE FREEZE PARTNERSHIP/S CORP

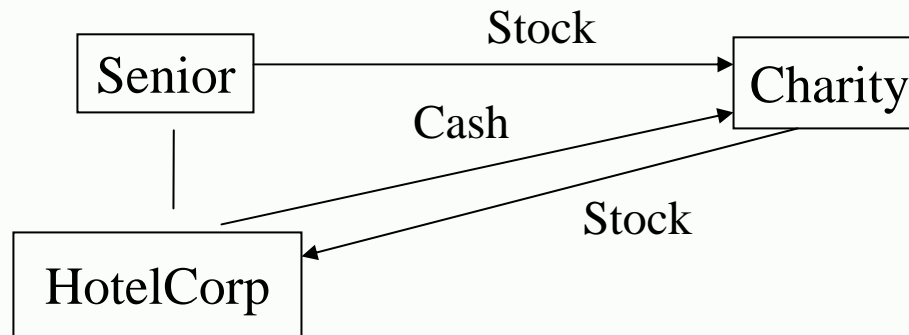


- Senior is advised that stock in HotelCorp, an S corporation, cannot be contributed to an FLP or LLC because a partnership/LLC is not a permitted S stockholder.
- HotelCorp and Junior form Freeze LLC. HotelCorp contributes all of its assets to Freeze LLC in exchange for a 1% Class A interest and the sole Class B interest. Junior contributes cash for a 99% Class A interest. The Class B interest entitles the holder to a cumulative preferred return of \$4 million and a \$50 million preference on sales, refinancings and liquidation.
- The Class A interests are residual interests that participate in appreciation over \$50 million, plus cash flow in excess of \$4 million.

## THE FREEZE PARTNERSHIP

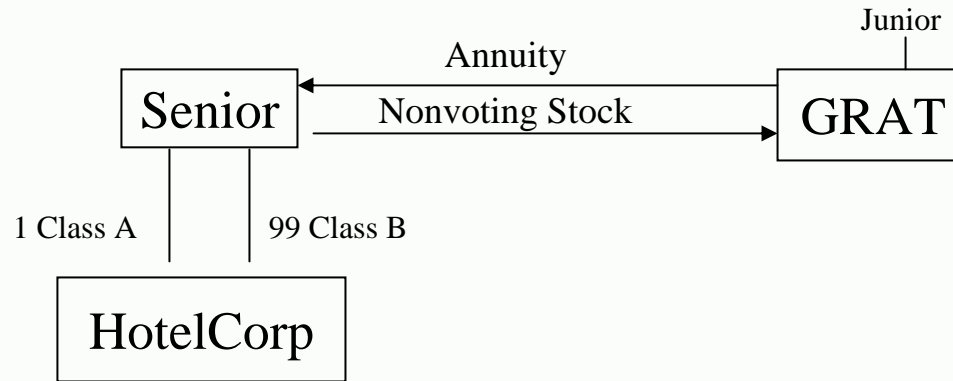
- Partnerships between a corporation and its stockholders and/or family members have been respected. But what is the business purpose?
  - Watch “sham” argument
  - Watch §701 anti abuse regs.
- Valuation must be accurate to avoid constructive dividend
- §704(c) will apply
- §482 could apply
- §2701 applies
- See also Pope v. Talbot, Inc. v. Com’r, 162 F.2d 1236 (9<sup>th</sup> Cir. 1999); TAM 200443032 (7/13/04).

# GIFT STOCK TO CHARITY/REDEMPTION



- Senior wishes to make a substantial charitable contribution. His tax advisors recommend using appreciated property. Senior transfers 10% of his HotelCorp stock to a 501(c)(3) organization. The value of the gifted stock is \$5 million according to Lowball (no discount applied!). After a “respectable” waiting period, HotelCorp agrees to redeem the stock from the charity for \$5 million.
- Note that 501(c)(3) organizations are permitted S corporation stockholders. But see §512(e) which provides that all income from S corporation is UBTI. Gain from the redemption would also be UBTI. If HotelCorp were a C corporation – no UBTI.
- Note that the redemption will strip out proportionate C corporation E&P.
- As long as there is no binding obligation on the part of the charity to redeem at the time of the gift, Senior succeeds in attaining a full charitable deduction with no gain recognition. See, e.g., Rev. Rul. 78-197, 1978-1 C.B. 83; Gerald Rauenhorst, 119 T.C. 157 (2002).
- Note valuation risks and charity may not like UBTI.

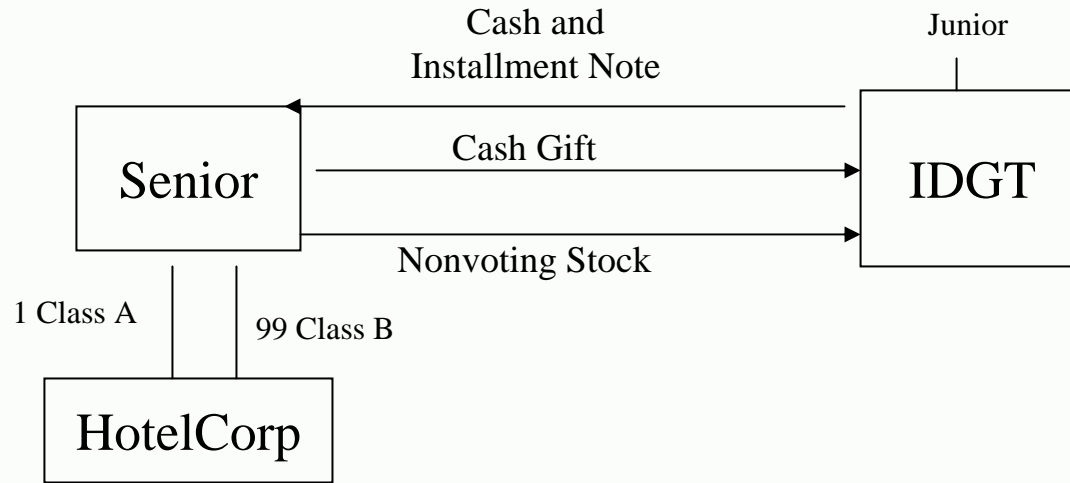
## USING GRATs



- HotelCorp has assets worth \$50 million. Senior recapitalizes HotelCorp with 1 Class A voting share and 99 Class B nonvoting shares (the shares are identical except for voting rights so no S corporation problem).
- The value of the 99 Class B shares, according to Lowball, should be discounted by 40% to reflect the minority interest and lack of marketability discounts as well as discounts for the potential built in gain tax. Thus, the 99 Class B shares, having a gross value of \$49.5 million, have a fair market value of \$29.7 million.
- Shark advises Senior to consider using a GRAT to which Senior would transfer the Class B shares.
- Shark would be the trustee of the GRAT and Junior and his children would be the beneficiaries. The GRAT would receive \$4.95 million in annual distributions from HotelCorp so, based upon the annuity tables, a 6.5 year annuity of \$4.95 million paid to Senior would “zero out” the gift portion of the transfer. Section 7520 Annuity tables apply. See Reg. §25.2702-3(e).

- Benefits of a GRAT:
  - Freezes value at a discount
  - Statutory support – §2702
  - If IRS attacks valuation, GRAT annuity adjusts, thereby avoiding gift tax problem.
  - GRAT is a grantor trust for income tax purposes so Senior pays income tax on GRAT earnings (further depletes Senior's estate).
  - Carryover basis
- Negatives of a GRAT:
  - Must make the annuity payments. Puts pressure on HotelCorp to make annual distributions – could hurt discounts.
  - Cannot prepay
  - If Senior dies before the annuity is fully paid, GRAT assets are included in Senior's estate (some practitioners believe only a portion of assets are included in estate). See Prop. Reg. §20.2036-1(a)(6/7/07).
  - No GST allocation until end of annuity period.
  - Payments at 7250 annuity table rates instead of AFR.

# USING IDGTs



- An installment sale to a defective grantor trust (“IDGT”) is a transaction that is similar to a GRAT. Both are designed to freeze value.
- Senior sells the 99 Class B Shares (worth \$29.7 million) to a grantor trust established by Senior for the benefit of Junior and his children. Shark will be the trustee.
  - Senior first makes a cash gift to the trust. 10% is rule of thumb but with larger numbers less is typically used (but perhaps coupled with a guaranty from solvent beneficiary). Lets say \$1 million to avoid a taxable gift (if Senior marries Nancy could also use Nancy’s \$1 million). Might get Junior to guaranty part of the installment note to increase “equity”. Lets say a \$2 million guarantee in exchange for an annual guaranty fee of \$20,000.

- Senior takes back a \$28.7 promissory note payable, say, interest only for 5 years and then principal and interest paid over next 5 years (no required structure – flexibility).
- For income tax purposes, the trust assets are still viewed as owned by Senior, so Senior is liable for income tax (good from estate planning perspective). For this reason, the installment sale does not trigger gain to Senior. Rev. Rul. 85-13, 1985-1 C.B. 184
- Basis of stock carries over to trust.

#### Benefits of IDGT:

- Freezes value; shifts current value to the extent of discount plus future appreciation
- Flexibility in structure of note (prepayment permitted). Less pressure to distribute from HotelCorp
- GST allocation permitted at outset of transaction
- Interest is at AFR not at 7520 annuity table rates

#### Negatives of IDGT:

- No express statutory support
- Valuation risk. No adjuster on note payments
- If Senior dies before note is satisfied, unpaid portion of note is included in Senior's estate (actually, compared to GRAT, this is a benefit).

NOTE: Consider using a private annuity instead of straight installment sale. Early death could create tax “home run”. Longevity could be tax problem.

## GIFTS OF PARTNERSHIP INTERESTS

- If Senior gifts an interest in Office LP to Junior, the valuation rules as previously discussed would apply. However, Senior should be aware that this gift will also produce adverse income tax consequences.
- When encumbered property is gifted, the transaction is characterized as a “part sale, part gift.” The “part sale” price is based on the premise that liability relief is treated as an amount realized for income tax purposes. To the extent the amount realized exceeds basis, gain is recognized. Reg. §1.1001-2(a).
- In Office LP, Senior has \$30 million of nonrecourse debt and \$20 million of basis in his interest. If he were to transfer his entire interest by gift, his entire negative capital account would be triggered into income. To the extent he gifts a portion of his interest, the same principle would apply.
- If Senior retains a partnership interest and if the partnership debt is fully recourse to Senior (economic risk of loss), no income tax problem should be triggered on the gift.
- Where there is a “part sale”, Donee receives a basis in the gifted partnership interest that reflects the “part sale” (and with a 754 election can get a 743 step up).
- Note: Gifts of Partnership interests to charity present the same part sale, part gift problem. In addition the charity may be concerned about UBTI either because of the character of the partnership’s income or the partnership debt financing.