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HOW TO DO

ESTATE PLANNING FOR REAL ESTATE CLIENTS

by

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November 2018

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HOW TO DO ESTATE PLANNING

FOR REAL ESTATE CLIENTS*

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Estate planning for real estate clients takes into account the following goals:

- **First**, clients need to plan who will manage their real estate, both during the client's lifetime and after the client's death.

- **Second**, upon the client's death, how can probate be avoided for that real estate?

- **Third**, clients may be concerned about creditor protection against potential liabilities generated by the real estate (such as lender claims, hazardous material liabilities, or possible future claims from construction defects).

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* No legal or tax advice of any kind is being given by this article. This article should not be relied upon for any client or transaction without first retaining qualified tax and estate planning professionals. Each estate plan and taxpayer has its own unique facts and circumstances, and therefore each estate plan and taxpayer's situation must be specifically analyzed and structured.

All Code references in this Article, unless otherwise stated, are to the Internal Revenue Code of 1986, as amended.

- **Fourth**, clients are concerned as to how can they protect their real estate from their creditors' claims.

- **Fifth**, clients want to minimize or eliminate any potential estate and gift taxes attributable to their real estate.

- **Sixth**, clients are concerned as to how any estate taxes which are attributable to their real estate will be paid upon their death.

- **Seventh**, clients may want to receive a step-up in their real estate's income tax basis upon both the client's death and the client's spouse's death.

- **Eighth**, clients owning California real estate acquired many years ago are concerned about Proposition 13 property tax reassessment due to that real estate's "change of ownership" caused by the clients transfers during lifetime or at death.

1. CURRENT STATUS OF ESTATE AND GIFT TAX LAWS

1.1 ***Current Estate and Gift Taxes***. This year, in 2018, there is a unified gift and estate tax exemption of $11,180,000 per person (which amount is scheduled to increase to $11,400,000 in 2019 and to increase in future years for inflation adjustments). The generation-skipping tax exemption amount in 2018 is $11,180,000, which amount is scheduled to increase to $11,400,000 in 2019, and increase in future years by an inflation adjustment. This increased unified exemption amount will sunset on January 1, 2026, to a $5,000,000 amount per person as adjusted for inflation.

The estate tax rate remains at 40% (along with the gift tax and generation-skipping tax rate).

1.2 ***Planning for Income Tax Basis Increase***. With the $11,180,000 unified gift and estate tax exemption in 2018 (which is scheduled to increase to $11,400,000 in 2019) real estate clients will want to keep at least this unified credit amount of assets in their taxable estate upon their death. If the client is married then with their real estate owned as community property the client will basically be able to double this amount since they will have one exemption amount for themselves and one exemption amount for their surviving spouse. In the past, clients have utilized bypass trusts (also known as "Decedent's Trust") to receive on the death of the first spouse that deceased spouse's assets up to the unified estate tax exemption amount. However, with this large increase in the estate tax amount (which, for example, will be $22,800,000 in 2019 for both spouses) clients will want to keep this $11,400,000 amount (as adjusted in the future) in the last to die spouse's estate in order to receive a step-up in income tax basis upon the deaths of both spouses. This goal can be accomplished by the following potential planning ideas:

- Use the portability provisions of the federal estate tax laws where the surviving spouse can use the deceased spouse's unified exemption amount plus the surviving spouse's unified exemption amount. The non-tax issues in utilizing this approach are that if the surviving spouse remarries then they will not be able to utilize the unified exemption amount of the first-to-die spouse. Additionally, the first-to-die spouse may want their assets to be in a QTIP trust to protect these assets should the surviving spouse remarry or decide to leave assets to someone other than the two spouses' joint children.

- In a community property state, such as California, both spouses' share of the community property receive a step-up in income tax basis upon the death of the first-to-die spouse. One goal is to design the estate plan so that these assets also receive a step-up in basis when the second spouse dies. Query, what if the assets go down in value thereby causing a reduction in income tax basis?

- Utilize a bypass trust with a formula, or with a special trustee who is allowed to give to the surviving spouse a general power of appointment so that the assets of the bypass trust are then included in the surviving spouse's estate upon the surviving spouse's death (thereby giving those assets a step-up in basis).

The increased unified estate and gift tax exemption amount under current Internal Revenue Code provisions will be eliminated in 2025. In all probability if the increased exemption is utilized prior to 2025 (and the exemption were to revert back to a lower amount) then there should not be a "clawback" of the increased exemption that is utilized. Regulations or IRS guidance on this topic are to be issued in the near future.

2. **<u>HOW SHOULD REAL ESTATE BE OWNED?</u>**

Clients may own real estate as follows:

- **<u>Community Property</u>**. In community property states (such as California) real estate can be titled in the spouses' names as community property.

- **<u>Joint Tenancy</u>**. Although this is a convenient way to avoid probate, the IRS could assert that in fact the real estate is <u>not</u> community property and deny a step-up in income tax basis for the surviving spouse's share of that real estate.

- **<u>Tenancy-in-Common</u>**. Many times clients will own real estate as tenants-in-common with other persons. A tenancy-in-common relationship (instead of community property ownership) among spouses may prevent the surviving spouse receiving a step-up in the income tax basis of the surviving spouse's share of the tenancy-in-common, since arguably the deceased spouse owned, as their "separate property," their tenancy-in-common interest in the real estate.

• **Revocable Transfer on Death Deed.** Used for single family residence or condominium unit, single family residence on agricultural property on 40 acres or less, or residence with no more than four (4) residential dwelling units. Can designate who the beneficiary is upon the property owner's death.

• **Revocable Living Trust**. Could have title to the real estate. See discussion below.

• **Legal Entity**. Real estate can be owned by a legal entity (to provide liability protection) such as a limited partnership (with a corporate or limited liability company as a general partner), limited liability company, or a corporation. See discussion below.

2.1 ***Protecting the Client Against Liabilities Generated By the Real Estate***. Today, because of concerns over liability protection (and also in order to generate valuation discounts for estate and gift tax transfer purposes), clients may want their real estate (other than their personal residence) to be owned in a legal entity, such as a limited partnership or limited liability company.

> **Examples of potential liabilities which real estate could generate would be: hazardous materials; slip-and-fall cases; disgruntled tenant claims; claims regarding mold; claims from the structural collapse of the real estate such as in an earthquake; claims by vendors and contractors; accounts payable; claims by tenants and tenant claims regarding security deposits; claims regarding recourse promissory notes secured by deeds of trust on the property; and claims based upon construction defects.**

Clients who feel that they can protect themselves against claims by purchasing insurance must realize that when they sell their real estate they may cease being an insured under the real property's liability insurance policy, and thus no longer have liability insurance coverage for future claims (as an example, hazardous materials claims are not covered under regular liability insurance policies).

It is advisable for clients who own portfolios of real estate to split their properties among multiple limited liability companies or multiple limited partnerships (with a corporation or limited liability company as the general partner) in order to not have "all of their real estate in one basket" if a liability is generated by one of the real properties.

2.2 ***What Form of Legal Entity Should Own the Real Estate?*** Even with the recent change in the federal corporate tax rate C corporation should be avoided as the owner of real estate since at the corporate level there will be a 21% Federal income tax, plus a California corporate income tax at 8.84%.

An S corporation doing business in California, although not having a Federal-level income tax on its earnings, will still be subject to the 1.5% California tax on its earnings. Additionally, with an S corporation the shareholders do not get a step up in their stock's income tax basis for corporate debt.[1] This lack of a step up in an S corporation shares' tax basis may cause unexpected capital gains to the shareholders upon distribution of that real estate's refinancing proceeds or other distributions from the S corporation.

Accordingly, for clients desiring liability protection, either a limited liability company or a limited partnership is generally the entity of choice to own real estate.

A limited liability company has an advantage over a limited partnership in that a limited liability company produces limited liability for all of its members, while a limited partnership produces limited liability only for its limited partners. Thus, in order to protect the general partner of a limited partnership from liability, the general partner should be either a corporation or a limited liability company.

For limited liability companies owning real estate in California or operating in California, there is a gross receipts fee imposed on the limited liability company.[2] California limited partnerships are not subject to this gross receipts fee.

2.3 ***Use of Revocable Living Trusts to Own the Real Estate or to Own Interests of Legal Entities That Own Real Estate***. In order to avoid probate, clients may choose to transfer their assets into a revocable living trust. Clients can transfer the title to their real estate directly into a revocable living trust, or for liability protection purposes may choose to first transfer their real estate to a limited partnership or limited liability company, followed by transferring these entity interests into a revocable living trust. A revocable living trust not only serves to avoid having the real property

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[1] See case of ***Donald Russell***, T.C. Memo 2008-246.

[2] LLCs must pay an annual fee based on the total LLC's income from all sources reportable to California. The annual LLC fee is: $900 if total income is $250,000 or more but less than $500,000; $2,500 if total income is $500,000 or more but less than $1,000,000; $6,000 if total income is $1,000,000 or more but less than $5,000,000; $11,790 if total income is $5,000,000 or more. See California Rev. and Tax. Code §17942(a).

Both limited liability companies and limited partnerships are also required to also pay an $800 annual California franchise tax under §§17941 and 19735 of the California Rev. and Tax. Code.

go through the probate process (with its time consumption and costs), but also serves to protect the privacy of the client.[3]

Real estate is transferred to a revocable living trust by executing a deed (either a grant deed or quitclaim deed). Care must be taken to obtain deeds of both spouses on deeds into a revocable living trust (even if the spouse is not named on the deed, since he or she may have a community property interest in that real estate).

2.4 ***Preserving the Income Tax Benefit of §121***. Section 121 is the income tax provision which states that a taxpayer may exclude up to $250,000 ($500,000 if married and filing a joint tax return or if sale occurs not later than two years after the date of death of spouse) of gain upon the sale of their personal residence. To qualify for this gain exclusion, the residence must have been owned and used by the client as their personal residence for two out of the five years immediately preceding the sale of the residence. While the residence is owned by a revocable living trust and both spouses are alive, the spouses can take advantage of §121.[4] However, if one spouse dies and a portion of the residence is allocated to a bypass trust (that is the portion qualifying for the Federal estate tax exclusion), then §121 may not apply to the bypass trust's ownership of the residence. In PLR 200104005 the IRS held that the §121 exclusion is only applicable to the surviving spouse's portion of the revocable living trust, and not to the bypass portion of such trust.[5]

2.5 ***No Prop 13 Reassessment of Real Estate's Transfer to a Revocable Living Trust For California Property Tax Purposes***. Transfers to a revocable living trust (or from a revocable living trust back to the trustors) is excluded from being a change of ownership under §62 of the California Revenue and Taxation Code.[6] Additionally, upon the death of the first-to-die spouse, when the real estate is allocated to an irrevocable trust (such as a QTIP trust or a bypass trust) where

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[3] A common device to protect the privacy of entertainment and well-known clients (since the deed is part of the recorded public record) is to title their personal residence in a generically named revocable living trust, with their business manager or other trusted person named as the trustee.

[4] Where a grantor trust owns the personal residence, the residence ownership is imputed to the grantor (or grantors for two spouses) under Reg. §1.121-1(c)(3).

[5] See also PLR 200018021 where an individual taxpayer who is only a trust income beneficiary was not deemed to be an owner for §121 purposes.

[6] See §62(d) of the California Rev. and Tax. Code.

the surviving spouse is the sole income beneficiary, that trust qualifies for the exemption from being a change of ownership for property tax purposes.[7]

2.6 ***Required Consents and Notifications of Lenders and Other Persons When Real Estate is Transferred to a Revocable Living Trust***.

(a) ***Insurance Policies***. When real estate (whether a personal residence or commercial real estate) is transferred into a revocable living trust, the property insurance company insuring that real estate should be notified and the trust designated as a loss payee. Additionally, the trust should be named as an additional insured on any liability insurance policy that the client may have.

(b) ***Lenders***. If the real estate which is transferred to a revocable living trust is encumbered by a deed of trust, then most deeds of trust contain a covenant whereby the lender can accelerate the loan if there is a "transfer." Transfers to revocable living trusts are normally covered by such broad deed of trust loan acceleration language unless a specific exception is included in the deed of trust document. Accordingly, clients should obtain the lender's consent when transferring real estate into a revocable living trust. The one exception is for the transfer to a revocable living trust of a personal residence.[8]

It is this author's experience that most lending institutions are willing to give their written consent to transfers of real estate into revocable living trusts where that real estate is encumbered by a deed of trust. However, lenders may require documentation and endorsements to title insurance policies, and may charge the client for the lender's costs to grant the lender's consent to the transfer.

(c) ***Leases***. If a real property from which the client receives rental income is transferred to a revocable living trust, then the property's tenant should be notified to make rental payments directly to the trust (rather than to the client/trustor).

2.7 ***Other State's Estate and Inheritance Taxation of Real Estate Located in These Other States***. California currently has no inheritance or pick-up estate tax.[9] However, if a decedent owns real estate in another state (whether owned outright on in a revocable trust), that real estate may be subject to the estate and inheritance taxes of that state in which the real property is located.

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[7] California Code Regs. §462.160.

[8] See ***Garn-St. Germain Depository Institutions Act of 1982***, at 12 USC §1701j-3(d)(8).

[9] See §13301 of the California Rev. and Tax. Code.

Thus, real estate owned by California residents in other states may become subject to that other states' independent estate (or inheritance) taxes.

It is possible that California residents may be protected by that other state's estate tax exclusion amount which is tied to the Federal estate tax exclusion. However, some states (so-called "decoupled states") may not follow the Federal estate tax exclusion, and a state estate tax (or inheritance tax) may be due for this out-of-state real property. Thus, a California resident may end up paying state estate or inheritance taxes on real estate located in other states.

To plan to avoid such out-of-state estate taxes (or inheritance taxes), California residents can: (i) consider selling their out-of-state real property while they are alive; (ii) making a lifetime gift of that out-of-state real property to family members; or (iii) converting that out-of-state real property to "personal property" that will then be deemed to be located in California for estate tax purposes, such as by conveying that out-of-state real property to a partnership or a limited liability company. For example, in order to avoid that other state's inheritance and estate taxes, a California resident might transfer their real property to a limited partnership or to a limited liability company. Thus, upon that California resident's death, the decedent's estate (or trust) would not own any real estate in such other state, but instead would own only personal property (in the form of limited liability company membership interests or partnership interests). This personal property would have a tax situs where that California resident lived (which is in California) and not in that other state. The ability to avoid another state's inheritance or estate tax by converting out-of-state real estate into personal property (such as limited liability company interests) will depend on that particular state's laws.

3. HOW WILL THE REAL ESTATE BE MANAGED AFTER THE OWNER'S DEATH OR RETIREMENT?

One often overlooked item in estate planning for real estate is how will that real estate be managed as the real estate owner grows older, and how will that real estate be managed after that owner's death.

Some real estate requires intensive management, such as a development company, large multi-family residential complexes, and retail shopping centers. On the other hand, a single triple-net leased building will require a lesser amount of management.

There might be conflicts within a real estate owner's family, such as between siblings who do not get along with each other, or among a second spouse and children from a first marriage.

An owner during that owner's lifetime may not want to give up control of their real estate operations because that owner feels that their spouse or children will not be able to properly manage the real estate.

In addressing how real estate will be managed after an owner's death or retirement, the following issues should be considered:

- Which family members (or other persons) does the owner desire to manage that real estate after the owner's cessation from management activities or that owner's death.

- Which children (or spouse) are capable of managing the real estate.

- Which family members will become involved in managing the real estate if the owner is no longer able to, or desires to, manage the real estate.

- Those specific family members that the property owner desires to manage that real estate may depend on who that owner intends to leave that real estate to upon that owner's death.

3.1 ***<u>The Owner Who Actively Manages Their Real Estate Must Consider the Needs of Their Spouse</u>***. In many cases the real estate is the major cash flow source for the owner. Thus, if the owner dies, that owner's spouse may require the real estate's cash flow for his/her support. Accordingly, the real estate owner may need to keep that real estate's cash flow in the surviving spouse's name (such as by a QTIP trust) until the later death of that surviving spouse.

3.2 ***<u>What Happens Where the Real Estate Requires Intensive Management and the Owner Retires or Dies?</u>*** When the owner who has been managing that real estate retires, that owner may still require that real estate's cash flow in order to pay their living expenses. This continued need for cash flow is one reason why senior family members many times want to retain lifetime control over their real estate's operations.

Some solutions to consider in order to provide cash flow to a retiring real estate owner are:

- Have the retiring owner receive cash flow in the form of a consulting agreement from the entity owning the real estate.

- Have the owner sell some or all of the real estate to his children or grandchildren in exchange for a promissory note paid and amortized over a specified number of years.

- Utilize the grantor retained annuity trust ("GRAT") or defective income trust planning techniques described at paragraphs 9.1 and 9.2, above.

3.3 ***<u>Planning the Succession of the Real Estate Where There is a Second Spouse and Children By the Client's First Marriage</u>***. This is a recipe for conflict. Some suggested solutions are:

- At the real estate owner's death, leave the real estate to a QTIP trust where the surviving spouse receives an income interest. Have an independent property management company manage the real estate. The trustee of the QTIP trust could be an independent trustee, or the owner could make the surviving spouse and the children co-trustees.

- Have the real estate owner and their second spouse have a property agreement (such as an antenuptial agreement) to protect the client against the surviving spouse claiming a "community interest" or other interest in the real estate. A property agreement provides certainty as to the real estate ownership and avoids future conflicts between the second spouse and the children by the first marriage.

- Consider not having the owner's surviving spouse involved in the real estate operations by leaving the surviving spouse other estate assets or have the surviving spouse only be an income beneficiary of the QTIP trust which owns the real estate.

- If the client's children are to manage the real estate upon the client's death, then consider leaving other assets (and not the real estate) to that second spouse, either outright or in a QTIP trust.

- The client could purchase a life insurance policy to provide an immediate cash payment to the second spouse, and then at the real estate owner's death leave the real estate solely to the children, with the surviving spouse receiving the life insurance proceeds.

3.4 ***<u>How Will the Real Estate Be Managed After a Client's Death?</u>*** The client who has developed the real estate may not have confidence that their children are capable of properly managing the real estate after that client's death or the client may perceive that their children are spendthrifts. In such cases the client may not want to give their children control of the real estate either during that client's lifetime or after that client's death. Some solutions to consider are as follows:

- Real estate management companies can be hired. However, these companies are generally conservative and will not have the same "hands on" approach that the client had in managing the real estate. For example, if there is a retail shopping center, then a management company may not have the "personalized" touch with the shopping center's tenants.

- The real estate could be put in an entity where the children are given limited partnership interests along with the owner. Control could vest in a trustee or in a board of trustees designated by the client.

- A board of directors or a board of trustees, which would control the real estate, could be established during the client's lifetime. The children or the owner's trusted advisors or professionals could serve on such a board.

- Have the real estate owned in trust after the owner's death. For tax planning purposes (and to obtain valuation discounts at the death of the second spouse), consider splitting and allocating the real estate (or legal entities which own the real estate) upon the death of the first spouse into multiple trusts (QTIP, Survivor's, and Bypass) in order to not have a majority of that real estate (or legal entity owning that real estate) in either the QTIP Trust or the Survivor's Trust.

3.5 ***What Happens When Only Some of the Client's Children Are Involved With the Management of the Real Estate?*** Many times only some of the client's children are involved with the management of the real estate. For example, if the client/owner allows only one child to manage that real estate during the client's lifetime, or only one child is involved in managing the real estate after the client's death, then the following factors should be considered in the client's estate plan:

- Provide for the payment of a fair management fee to the working child (who is managing the real estate).

- Allocate the real estate assets under the client/owner's Will and trust to the managing child, while allocating the non-real estate assets to the non-managing children. This type of planning will only work if there are enough non-real estate assets to allocate to the non-managing children.

- Split up the real estate at the client's death so that the child who manages the real estate receives only those specific real properties which that child manages. The other real properties could then be allocated to the non-managing children, and those non-managing children could then hire a property management company to manage their real estate.

3.6 ***What Happens Where There Are Multiple Children Working in the Family's Real Estate Business?***

- Consider having provisions in the trust document, and in the partnership entity which owns the real estate, spelling out how the children will conduct the real estate business and how the children will vote.

- Provide for what happens to the real estate upon the death of one of the children. Should that child, upon that child's death, be able to leave their share of the real estate to that child's spouse and family, as opposed to having a buy-out agreement in order to keep the real estate owned by the original family?

3.7 ***<u>What Happens If There Are No Children to Run the Real Estate Business?</u>*** Many times children who have other career opportunities do <u>not</u> want to help to manage the family's real estate assets. What happens where the client/parent has real estate operations (such as shopping centers or apartment buildings), but none of their children desire to work in that real estate's business operations? Some solutions and considerations are as follows:

- Sell the real estate upon the parent's death. However, the parent may not be able to achieve estate tax valuation discounts if the real estate is sold immediately at death, as discussed in paragraph 4, below.

- Consider hiring an outside real estate management company to manage the real estate upon the client's death.

- Include provisions in the client's trust document directing the trustees to sell the real estate upon the death of the surviving spouse (when also may have higher income tax basis to thereby reduce income taxes). Alternatively, might consider selling the real estate after the death of the first spouse, since at that time the income tax basis of the real estate will have been adjusted under §1014, which would thereby eliminate or significantly reduce any potential income taxes on the real estate's sale.

- Consider having the real estate operations continue after the client's death under the control of a trust with an independent trustee (such as a bank or board of trustees composed of the client's family members and trusted advisors). These trustees in turn can hire a property management company.

3.8 ***<u>What Management Considerations Apply to Those Clients Who May Be the General Partner of Many Limited Partnerships (or the Manager of Many Limited Liability Companies) Having Outside Investors?</u>*** It is common for real estate promoters to bring outside capital and investors into limited partnerships and limited liability companies, while they serve as the manager of those limited liability companies or the general partner of those limited partnerships. Investors in partnerships and limited liability companies rely upon the business expertise and the abilities of the client who is the real estate promoter.

In addition to the issue of how these various legal entities will be managed in the event of the retirement or death of the client/real estate promoter, most real estate ventures provide that the promoter will receive some form of a "promotional interest." For example, the entity's distribution provisions may provide that the investors first receive a return of their capital plus a specified percentage return. Monies thereafter may then be split between the promoter (which might be anywhere between 50/50 to 20/80 split) and the investors. The partnership agreement and limited liability company agreement should allow the promoter to assign such promotional interests to the promoter's family as limited partners for estate planning purposes. The investors, however, may want the promoter to reduce their promotional interests in the event of the promoter's untimely death or retirement (because the promotional interest is being given to the promoter for anticipated future services in the development, management and promotion of the real property venture). One solution to this issue is to have a life insurance policy taken out on the life of the promoter and the proceeds payable to the partnership or limited liability company, and then have these life insurance policy proceeds utilized (upon the promoter's death) to hire a real estate management company.

As to the management of the real estate partnerships and limited liability companies, the following items should be considered for succession planning in the event of the death or retirement of the client who is the promoter and manager:

- Provide for the partners or members to elect a new general partner and manager by a majority vote.

- If the promoter is a legal entity (rather than an individual), the promoter should provide for individual successors to take over in the event of the principal's death or disability. Life insurance on the principal might be taken out in order to ease this transition.

- If there are individual promoters, then the partnership or limited liability company operating agreement can provide for specific named successor managers in the event of the death or disability of the promoter.

- Analyze if the real estate promoter's children (or spouse) are capable of taking on the responsibilities of being the general partner or manager should the promoter die or become disabled.

4. VALUATION OF REAL ESTATE FOR ESTATE PLANNING PURPOSES

In order to do estate planning for real estate, to value real estate at death or to plan for a gift of that real estate, the real estate's value needs to be ascertained. Estate taxes are based upon the fair market value of the real estate at date of death (with the exception that the alternate valuation date may be utilized, which is that date six months after the date of death). Gift taxes and generation-skipping taxes also use the fair market value of the real estate. Finally, for income tax purposes the tax basis of the real estate acquired from a decedent is its date of death fair market value (or alternate valuation date value) under §1014(b).

For the estate and gift tax laws, the "fair market value" of the real estate is defined in the Regulations as that price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.[10]

For income tax purposes clients will desire to have a higher value to their real estate in order to reduce potential tax on the sale of real estate and to increase depreciation deductions. However, if the client's estate will become subject to a federal estate tax (upon the death of the client or the client's spouse) then the goal in valuing the real estate will be to lower the value for federal estate tax and gift tax purposes.

4.1 ***Real Estate is Valued For Federal Estate Tax Purposes Based Upon Its Highest and Best Use***. In order to determine the fair market value of real estate for Federal estate and gift tax purposes, the real estate is valued at its highest and best use as of the particular valuation date.[11] The highest and best use is the amount which would be paid by a willing buyer to a willing seller, neither being under the compulsion to buy or sell, and both having reasonable knowledge of relevant facts.[12] The highest and best use is not necessarily the use to which the property is then being used, but instead is that use which the property could be utilized in order to produce a greater return or benefit.[13]

4.2 ***Reduction in Estate and Gift Tax Value For Certain Items***. The estate and gift tax value of the real estate may be reduced for such items as environmental clean up of hazardous materials on the property, the real estate's location in a flood plain, a building moratorium, or other land use restrictions imposed by governmental bodies.

4.3 ***Property Tax Values Are Not Determinative For Gift and Estate Tax Purposes***. Under the Treasury Regulations for estate and gift tax purposes the real estate cannot be valued at its assessed value for property tax purposes unless that property tax value represents the real estate's fair market value.[14]

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[10] See for estate taxes Reg. §20.2031-1(b), and for gift taxes Reg. §25.2512-1.

[11] See ***Frazee***, T.C. 554 (1992).

[12] See Reg. §20.2031-1(b).

[13] See ***Estate of Feuchter***, 63 T.C.M. 2104 (1992), where the value of agricultural land was increased to what the land value would be for developing residential uses or other development.

[14] See Reg. §20.2031-(b). Property tax values in many cases have no relation to fair value. For example, in California Proposition 13 limits the amount of a property's assessed value increase in any given year.

4.4 ***Accepted Appraisal Valuation Methods For Real Estate***. In order to determine the highest and best use of the real estate, the three accepted appraisal methods for real estate are:

- **Comparable Sales of Property Methods** based upon recent arm's-length sales of similar properties. Adjustments then have to be made to comparable properties, such as for differences in condition, size of the property, availability of utilities, land use restrictions, frontage on major highways, and other factors.

- **Capitalization of the Net Operating Income Method**. Under the capitalization method, the income of the property is determined and then is capitalized by dividing that income by a selected capitalization rate. There are different theories on what can be deducted from income before the capitalization rates are applied. To reduce value some people argue that depreciation and interest can be deducted. The determination of the capitalization rate amount takes into account the risk of the real estate ownership, real estate's lack of liquidity, and the probability of a real estate's rental stream increasing in the future. For example, in a recessionary economy, the capitalization rates of real properties can be four to five percent greater than what they were in a non-recession economy.

- **Cost of Replacement Method** is used less frequently. It is most helpful where you may have a unique piece of real property, such as a church or a sports arena. Under this method the cost of the land plus the replacement cost of the structure and improvements are added together (which costs of improvements may be based upon a square foot cost amount) and there is then deducted the physical obsolescence, depreciation, and the repairs required of the real property.

4.5 ***Valuation Discounts For Fractional Interests in Real Estate***. Real estate owned as a tenancy-in-common (sometimes known as fractional ownership) is entitled to a valuation discount. Valuation discounts will also apply to entity interests of entities which own real estate, such as family limited partnership interests or limited liability company membership interests (see discussion at paragraph 5, below).

(a) ***What is the Theory Behind Valuation Discounts For Fractional Interests?*** If a client owns only a tenancy-in-common interest in the real estate, then there are fewer buyers for that tenancy-in-common interest than if the client owned a 100% fee interest in the real estate. Even though a tenant in common can initiate a partition action, asking a court to divide the real property or to force a sale of that real estate is much less desirable than if an entire fee interest in that real estate is offered for sale.

(b) ***Criteria By Which Courts Will Find Valuation Discounts For Fractional Interests in Real Estate***. The Tax Court not only finds the costs of the partitioning a fractional interest in real estate justifying a valuation discount for fractional real estate interests, but also will look to the limited market for selling a fractional interest, the limitations on having unified management of fractional interests in the same property, and the fact that there is a lack of control where a fractional interest is owned.[15] The IRS in the past has argued that the only valuation discount for a fractional interest should be the costs of doing a partition action.[16] The IRS was successful in making this argument in the case of ***Andrew K. Ludwick***.[17] In ***Ludwick***, the issue was the value of a tenancy-in-common interest in a personal residence. The Tax Court in using the cost of a partition action to value the tenancy-in-common interest, presumed that a partition action would take 2 years to resolve and assumed an increase in value until the partition date as well as a discount rate to determine the present value of the projected sales proceeds.

(c) ***What is the Amount of Valuation Discounts For Fractional Tenancy-in-Common Interests in Real Estate?*** The valuation discount will be based upon an appraisal. In the ***Baird Estate*** case the Tax Court allowed a 60% discount for minority fractional interests in timberland. On the other hand, in ***Estate of Busch***[18] the Tax Court only allowed a 10% valuation discount where the decedent owned a 50% tenancy-in-common interest (based on the costs of partitioning the property). In ***Estate of Wildman***[19] the Tax Court stated that a 40% valuation discount was allowed for a 20% undivided tenancy-in-common interest in a farm. In ***Estate of Sels***[20] the Tax Court allowed a 60% valuation discount for a tenancy-in-common interest in timberland. In ***Estate of Augusta Porter Forbes***[21] the Tax Court permitted a 30% valuation discount where a trust owned a minority fractional interest in the real property. In another Tax Court case, a 44% valuation discount was allowed in valuing undivided one-half interests in several parcels of timberland.[22] On the other hand, only a 10% valuation discount was allowed where a 50% tenancy-

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[15] See ***Baird Estate***, T.C. Memo 2001-258.

[16] See TAM 199943003.

[17] T.C. Memo 2010-104

[18] T.C. Memo 2000-3.

[19] T.C. Memo 1989-667.

[20] T.C. Memo 1986-501.

[21] T.C. Memo 2001-72.

[22] See ***Estate of Ellie B. Williams***, T.C. Memo 1998-59.

in-common interest in farm land was owned, with the other 50% tenancy-in-common interest being owned by a trust benefitting the decedent's sister-in-law.[23]

Even where the decedent may have owned a majority interest in the fractional interests (such as a 77% undivided tenancy-in-common interest), a 15% valuation discount was allowed since the owner of a 77% tenancy-in-common interest still required the consent of the minority tenants in common to exercise ownership rights.[24]

(d) ***Valuation Discounts For Real Estate Which is Community Property***. Where a particular parcel of real estate is owned by two spouses as community property, taxpayers have been successful in arguing that a deceased spouse's community property interest is entitled to a fractional valuation discount (since the deceased spouse only owned a one-half interest as community property). This taxpayer position was upheld by the Ninth Circuit Court of Appeals in the case of ***Propstra***[25] where a 15% valuation discount was found for a community property interest in real property.

However, if two spouses (or other persons) own property as joint tenants, there is no valuation discount under ***Estate of Young***[26]. The reason is that §2040 requires that jointly owned property be included to its entire fair market value. Also, the Tax Court pointed out that a surviving joint tenant immediately comes into possession of both parts of the joint tenancy upon the first joint tenant's death.

(e) ***Valuation Discounts Where a Fractional Interest in Real Estate is Owned By a QTIP Trust***. Commonly, upon the death of the first-to-die spouse the family's trust assets (including real property) is split into equal shares between the survivor's trust (representing the community property share of the surviving spouse) and the QTIP trust or the bypass trust (representing the deceased spouse's share of the community property). This split of assets between these trusts can later create a valuation discount upon the death of the second spouse since the QTIP trust only owns a fractional interest in the real property. Courts have rejected the IRS's argument that the interests of the QTIP trust and the survivor's trust should be merged for valuation purposes

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[23] See ***Estate of William Busch***, T.C. Memo 2000-3.

[24] See ***Estate of Eleanor Pillsbury***, T.C. Memo 1992-425.

[25] See ***Propstra***, 50 AFTR 2d 82-6153 (9th Circ. 1982).

[26] See 110 T.C. 297 (1998).

(and thereby deny a valuation discount) in ***Estate of Bonner***[27]. A 20% valuation discount was allowed for land owned as community property in ***Estate of Ila Anderson***[28]. The IRS has acquiesced to the ***Mellinger***[29] decision which held that interests in property which are included in the decedent's taxable estate because such property is held in a QTIP trust (and represents the property of the decedent's predeceased spouse) is <u>not</u> aggregated for estate tax valuation purposes with interests in that same property which may be owned directly be the decedent (such as the decedent's share of the community property held in the survivor's trust).

4.6 ***<u>Use the Special Valuation Rules of</u>*** <u>§</u>***<u>2032A For Real Estate</u>***. Because the Treasury Regulations state that real estate is valued at its fair market value, which in turn is its "highest and best use," this could cause a hardship for persons owning farms and closely held businesses. For example, owners of farms could find that their farm is being appraised as a subdivided residential subdivision or for commercial use, which would substantially increase its value and impose much higher estate taxes on the farm owner. Such "highest and best use" standard may cause farms or closely held businesses to go out of business because their income potential would not be great enough to pay the estates taxes. Closely held businesses' real estate and farms would then have to be sold in order to pay estate taxes. Thus, to address this valuation problem for farms and closely held businesses (including the value of real estate used in a business), Congress enacted a <u>special valuation rule</u> for certain qualifying real estate under §2032A.

(a) ***<u>General Description of a</u>*** <u>§</u>***<u>2032A Election</u>***. Real property used for a farm or for a closely held business can be valued based on its current use (rather than on its potential highest and best use) if certain conditions are met. The estate's personal representative must make an election on the decedent's estate tax return for §2032A to apply.[30] In connection with this personal representative election, all parties having an interest in that real property (whether or not they are then in possession of that real property) must sign a written agreement consenting to the imposition of, and personal liability for, any estate taxes assessed in the event that within ten years of the decedent's death certain specified events occur under §2032A(c).

(b) ***<u>Amount of Decrease in value of Real Estate Under §2032A</u>***. <u>The total decrease</u> in the value of qualified real property included in the decedent's gross estate which results from applying the §2032A special valuation rules <u>may not exceed</u> $1,140,000 (for decedent's dying

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[27] 77 AFTR 2d 96-2369 (1996 Ct. of App. 5th).

[28] T.C. Memo 1988-423. The Tax Court cited ***Estate of Andrews***, 79 TC 938 (1982), in rejecting the IRS arguments that there should be unity of ownership.

[29] 112 TC 26 (1999), acq. 1999-35.

[30] See §2032A(d).

in 2018).[31] If more than one farm or business property is utilized and this limitation is exceeded, then the reduction is allocated ratably among all of the business and farm properties for which the special valuation rule is elected. These special valuation amounts then establish the income tax basis for such real property.[32]

(c) ***Requirements to Apply the Special Valuation Rule of §2032A***. In order for the real property to qualify under the special valuation rules of §2032A, the following requirements must be met by the real property and by the estate:

(i) The real estate used in a farm or closely held business qualifies for the §2032A special use valuation if the adjusted value of that real estate and all personal property used in such farm or closely held business accounts for at least 50% of the adjusted value of the gross estate.[33]

(ii) The adjusted value of the real estate must equal at least 25% of the adjusted value of the gross estate.[34]

(iii) There are special rules for valuing the farm under §2032A(e)(7)(A).

(iv) On the date of the decedent's death the real estate must have been used by the decedent or a decedent's family member as a farm or for a business purpose. Additionally, for at least five of the last eight years preceding the decedent's death, the decedent or a family member must have owned such real property and used such real property for farming or other business purpose.[35]

(v) The decedent or a family member must have materially participated in the operation of the farm or other business for at least five out of the last eight years preceding the decedent's death, disability, or commencement of social security retirement benefits.[36]

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[31] This amount is adjusted for inflation. This amount was originally a $750,000 limitation amount.

[32] See §1014(a).

[33] See §2032A(b)(1)(A).

[34] See §2032A(b)(1)(B).

[35] See §2032A(b)(1)(C).

[36] See §2032A(b)(1)(C) and (4).

(vi) If the real estate is owned in a partnership or a trust, it can still qualify for the special use valuation.[37] However, the real estate must be shown as being used in the farm or trade or business, and not just held for passive rental purposes.

(d) ***Triggering of Recapture of Estate Tax Under §2032A***. If after §2032A is utilized by the estate the qualified real property is disposed of (other than to a member of the qualified heir's family) or there is a failure of the qualified heir to continue to use the qualified real property for its qualified use (as stated in §2032A(c)(6)), then an additional estate tax (sometimes referred to as a "recapture tax") will be imposed.[38] This additional estate tax may be imposed within 10 years after the decedent's death.

(e) ***Analyzing Whether a §2032A Special Valuation Election Should Be Made***. Although this special valuation election may provide estate tax relief, it is complex, there is the potential for later estate tax recapture, and there is continuing personal liability of the qualified heir. These issues are magnified where there are multiple qualified heirs, since there is a risk that these heirs may disagree among themselves regarding the disposition of the real property and the fact that the election is causing a lower income tax basis. Thus, if this qualified §2032A real estate is sold in the future, there may be more gain to be recognized on such sale.

The special use valuation of §2032A should not be utilized where all of the assets are being left outright or in trust to the surviving spouse (which qualifies for the unlimited marital deduction). This is because there is no estate tax due, and it would reduce the real property's income tax basis which would be disadvantageous to the surviving spouse.

5. TYPES OF VALUATION DISCOUNTS THAT APPLY TO PARTNERSHIP OR MEMBERSHIP INTERESTS IN ENTITIES OWNING REAL ESTATE

Using legal entities such as family limited partnerships and limited liability companies to own real estate can produce valuation discounts, which in turn reduces gift, estate, and generation-skipping taxes when transferring the real estate to other family members.

Valuation discounts for minority interests and lack of marketability are well established by case law and are recognized by the Internal Revenue Service.[39] See Rev. Rul. 93-12 where the IRS

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[37] See §2032A(g).

[38] See §2032A(c).

[39] The IRS acknowledged in a redacted version of ***IRS Appeals Settlement Guidelines on Family Limited Partnerships and Family Limited Liability Corporations***, effective October 20, 2006, that (continued...)

held that a gift tax valuation discount for a minority interest is allowed even where gifts are made to family members.[40] In other words, there is no family attribution rule to deny minority and lack of control valuation discounts.

In the past there have been proposed federal tax changes by Treasury Regulations to have attribution of ownership among family members apply for valuation purposes, and there have been legislative proposals to repeal valuation discounts among family members.

5.1 ***Lack of Marketability Valuation Discount***. The lack of marketability valuation discount applies to FLP limited partner interests (or non-controlling membership interest in an LLC) based upon the fact that there is a limited ability to sell such interests. In other words, a partner of a non-publicly traded FLP interest will have more difficulty than an owner of publicly traded stock in finding a willing buyer. The price of publicly traded stock already reflects a lack of control discount, but does not reflect a lack of marketability discount because such publicly held stock is already being traded on a nationally recognized stock exchange.[41] Some appraisers have based lack of marketability valuation discounts upon studies of restricted stock and initial public offerings.

5.2 ***Minority and Lack of Control Valuation Discount.*** The minority and lack of control valuation discount is based upon the fact that the limited partner (or LLC member) is not able to control the management, distribution and investment decisions of the FLP. Some appraisers have based minority discounts upon closed-end mutual funds or real estate investment trusts.[42]

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[39](...continued)
there "is now a set of recognized criteria that estate planners can use in establishing family limited partnerships..."

[40] In Rev. Rul. 93-12, 1993-1 CB 202, the IRS said that a minority valuation discount will not be disallowed solely because the gifted interests to family members, when aggregated, would amount to a controlling interest.

[41] See, for example, ***Lappo***, T. C. Memo 2003-258, where the court allowed a 21% lack of marketability discount based upon the IRS's expert.

[42] See, for example, ***Dailey***, T. C. Memo 2001-263, where the Tax Court allowed a combined minority and lack of marketability discount of 40% for a FLP owning securities.

5.3 ***Discount for Tax Liabilities***. The valuation discount for tax liabilities which applies C corporations is not recognized by the IRS for pass-through entities such as partnerships or S corporations.[43]

5.4 ***Layering of Discounts***. In doing a valuation appraisal of a FLP interest, first the assets owned by the FLP must be appraised, and second the business appraiser must appraise the actual FLP partnership interest. Therefore, it is possible to have two valuation discounts affect FLP partnership interests. For example, if a fractional interest in rental real estate (such as a tenancy-in-common interest) is contributed to the FLP, that fractional real estate interest is entitled to a valuation discount, and there is a second minority and lack of marketability valuation discount applied to the FLP limited partner interests. See paragraph 4.5 for valuation discounts for fractional tenancy-in-common interests in real estate.

Similarly, the FLP could own minority interests in other subsidiary limited partnerships, which subsidiary partnership interests may also be entitled to minority and lack of marketability valuation discounts.

5.5 ***Importance of Obtaining a Qualified Appraisal to Justify Valuation Discounts***. An experienced business appraiser should be retained to prepare a "qualified appraisal" of the FLP partnership interests, along with the underlying real estate. The determination of minority or lack of marketability valuation discounts is based upon the specific facts of the FLP interest being valued and cannot be based upon the amount of valuation discounts in a particular published tax case decision.

The use of an appraiser is especially important when a Federal Gift Tax Return Form 709 or a Federal Estate Tax Return Form 706 is filed. The gift tax statute of limitations will only run on a Form 709 Federal gift tax return where there is a qualified appraisal.

The appraisal report should contain all relevant data and reasoning, and that the appraisal report relate to and analyze the specific facts and circumstances of the gifted, sold, or bequeathed FLP interest.

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[43] For the IRS position that there is no reduction for income tax liabilities in valuing partnership interests, see ***Temple***, 97 AFTR 2d 2006-1649 (D.C. Tex. 2006). For the rule that there is no valuation reduction for taxes in valuing S corporation stock, see ***Robert Dallas***, T. C. Memo 2006-212; and ***Gross*** T. C. Memo 1999-254, *aff'd* 272 F.3d 333 (6th Cir. 2001). In the C Corporation context the Courts have held that the valuation of a corporation may be reduced by the full amount of the tax liability of the inherent gain in a C Corporation's assets in the case of ***Dunn***, 90 AFTR 2d 2002-5527 (5th Cir. 2002) and ***Jelke***, 100 AFTR 2d 2007-6694 (11th Cir. 2007).

5.6 ***Should the FLP Be Formed in California or in Another State?*** If the FLP (or limited liability company) owns California real estate, then the income of that real estate will be California-source income subject to California taxes. Additionally, the foreign limited partnership or foreign limited liability company will still have to qualify and be registered in California as a foreign partnership or foreign limited liability company.

Some tax professionals feel that forming the FLP in certain states can take advantage of that state's more restrictive limited partnership or limited liability company laws. For example, Delaware and Nevada have, in some cases, more restrictive laws than does California.

This issue arises in the application of §2704, a provision under Chapter 14. Section 2704 provides that any "applicable restriction" in the partnership agreement is to be disregarded in valuing the FLP. An applicable restriction is defined to be a restriction that limits the ability of the partnership to liquidate, and such restriction either lapses after a transfer or the transferor and members of the transferor's family, alone or collectively, have the right to remove that restriction.[44] Importantly, a restriction is not an "applicable restriction" if it is not more restrictive than the limitations under the applicable state law. Depending on who the general partners and limited partners are, certain state laws may be more favorable to prevent liquidation or withdrawal of a partner from the FLP.

6. AVOIDING IRS ATTACKS OF FAMILY LIMITED PARTNERSHIPS UNDER §2036 BY HAVING A BONAFIDE SALE AND A BUSINESS PURPOSE FOR THE REAL ESTATE PARTNERSHIP

Most recent IRS successes in attacking FLPs have been under §2036.[45] For the IRS to include property in the decedent's gross estate under §2036, the following three items must all be shown:

(a) the decedent must have made a transfer of the property during the decedent's lifetime;

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[44] See Reg. §25.2704-2(b).

[45] In addition to §2036, the IRS has also attacked FLPs under §2038. Section 2038 provides that the value of a decedent's gross estate will include the value of all property "[t]o the extent of any interest therein, which the decedent has at any time made a transfer (except in case of a bonafide sale for an adequate and full consideration in money or money's worth).... where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, by the decedent alone or in conjunction with any other person...to alter, amend, revoke or terminate...." Most recent FLP tax cases have focused on the IRS's §2036 arguments, rather than §2038.

(b) that transfer must not have involved a bonafide sale for an adequate and full consideration in money or money's worth; and

(c) the decedent has either: (a) retained possession or enjoyment of the property transferred or the income from the property (known as a "Section 2036(a)(1)" retention); or (b) the decedent either alone or in conjunction with any person has retained the right to designate the persons who will possess or enjoy the property or the income from such property (known as a "Section 2036(a)(2)" retention).

The decedent's retained right under §2036 can be either by an express agreement, or by an "implied" agreement or understanding at the time of the decedent's transfer of the property pursuant to Regulation §20.2036-1(a). The Tax Court has found an implied understanding between a decedent and a FLP of the right to enjoy the transferred assets based upon facts and circumstances, where the decedent transferred substantially all of their assets to the FLP and made no other arrangements for their estate to pay their federal estate taxes.[46]

Thus, the IRS's attacks on FLPs under §2036 are based upon the allegation that the deceased client "retained" a prohibited interest in the FLP's assets.

In ***Estate of Powell***[47] the Tax Court held that liquid assets transferred to a family partnership right before the taxpayer's date of death were included in the taxpayer's estate for federal estate tax purposes. This decision was based in part that the partners (including the taxpayer) could liquidate the partnership by unanimous agreement (which the Tax Court then utilized this liquidation right to impose §2036(a)(2) as a prohibited retained power in the taxpayer).

6.1 ***The "Adequate and Full Consideration" Exception to §2036***. One often used taxpayer defense to prevent the application of §2036 is to prove that the decedent transferred FLP interests to the family members (or that assets were contributed by the decedent to the FLP) in a bonafide sale "for an adequate and full consideration" in money or money's worth. In order to apply this "adequate and full consideration" exception to §2036, recent court decisions have required a non-tax reason for the establishment of the FLP.

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[46] See ***Erickson***, T. C. Memo 2007-107. In ***Erickson*** there was a delay in the transfer of the assets to the FLP, the decedent died shortly after the asset transfers were completed, and the FLP provided the decedent's estate with the funds to pay the estate's taxes and liabilities. Also see the Ninth Circuit Court of Appeals decision in ***Estate of Virginia A. Bigelow***, 100 AFTR 2d 2007-6016 (9th Cir. 2007), where there was an implied agreement for the decedent to retain the economic benefits of the assets transferred to the FLP.

[47] 148 T.C. No. 18 (2017)

In other words, for the IRS to apply either §2036(a)(1) or §2036(a)(2) to a client's contribution of property to a FLP (or to a transfer of the deceased client's FLP partnership interest), the decedent must have first made a transfer of assets to the FLP (or a transfer of a FLP partnership interest) without receiving adequate and full consideration, and second, the decedent must have retained a prohibited interest in, or control of, the FLP for the remainder of the decedent's life. Thus, if it can be evidenced that the deceased client, upon transferring assets to the FLP, received in exchange adequate and full consideration for such transfer (such as receiving FLP partnership interests in exchange for the client's transfer of property to the FLP), there is arguably no gratuitous transfer upon the formation of the FLP, and thus, §2036 should not apply.[48]

Here in California, to qualify for the "bonafide sale" exception to §2036, the Ninth Circuit Court of Appeals in ***Estate of Virginia A. Bigelow***[49] held that the transaction must "be made in good faith," which requires an examination as to whether there was some "legitimate and significant nontax reason" for the FLP's formation.

In the ***Thompson***[50] case, the Third Circuit held that the "adequate and full consideration" exception to 2036(a) does not apply where the FLP's assets were not invested in a business enterprise motivated by legitimate business concerns.

In the Tax Court Memorandum decisions of ***Rosen***[51], and ***Hurford***[52], and the Ninth Circuit's ***Bigelow***[53] decision the Courts stated that in order for a reason for the FLP's formation to qualify as

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[48] The taxpayer was successful using this argument in ***Church***, 85 AFTR2d 2000-804 (W.D. Tex. 2000), *aff'd*, 88 AFTR 2d 2001-5352 (5th Cir. 2001).

[49] 100 AFTR 2d 2007-6016 (9th Cir. 2007)

[50] ***Betsy Turner, Executrix of the Estate of Thompson***, 94 AFTR 2d 2004-5764 (3rd Cir. 2004), *affm'g* T. C. Memo 2002-246. Importantly, the Third Circuit Court of Appeals in ***Thompson*** found that even receiving a discounted FLP interest could still, in certain circumstances, be "adequate consideration" for the "adequate and full consideration" exception to §2036.

[51] See ***Rosen***, T. C. Memo 2006-115. ***Rosen*** followed the prior Tax Court's decision in ***Bongard***, 124 T.C. 95 (2005).

[52] See ***Hurford***, T.C. Memo 2008-278.

[53] ***Supra***, note 56. The Ninth Circuit in ***Bigelow*** rejected the estate's position that the FLP had a business purpose. First, the Court rejected the estate's claim that the FLP provided liability protection. Second, the Court found that forming the FLP for gifting purposes is a testamentary

(continued...)

a "legitimate and significant nontax reason", that "reason" must be an important one that actually motivated the formation of the FLP from a business standpoint. The Tax Court in the ***Estate of Anna Mirowski***[54] found the business purpose of jointly managing the family's assets as being a sufficient business purpose to apply the "adequate and full consideration" exception of §§2036 and 2038.

Similarly, in the Tax Court case of ***Estate of Miller***,[55] the Tax Court applied the "bonafide sale for adequate and full consideration" exception of §§2036 and 2038 because the Court found the existence of a legitimate and significant non-tax reason for creating the FLP. Here, liquid securities were transferred to the FLP, partnership formalities were observed, and there was the business purpose of an active management of the securities. The Tax Court emphasized that the FLP ensured that the decedent's securities continued to be actively managed according to the decedent's late husband's investment philosophy.

(a) ***List the Business Reasons and Properly Draft the FLP Partnership Agreement***. To evidence a "legitimate and significant non-tax reason" for the FLP's formation, it is helpful if the FLP's "business reasons" are listed. Additionally, the FLP partnership agreement should provide that: (i) the assets contributed to the FLP will be properly credited to each partner's capital account; (ii) each partner's FLP partnership interest will be proportionate to the value of the assets that each partner contributes; and (iii) the FLP's distributions will be debited to the appropriate partner's capital account.

(b) ***Be Careful On the Reasons For the FLP's Formation Which Are Stated in Correspondence and E-mails to the Client***. Do not state in e-mails and correspondence to the client that the FLP is being formed only to save taxes. Instead, evidence the nontax reasons for the FLP's formation.

Some nontax reasons for forming a FLP are discussed below:

6.2 ***Evidence That the FLP is Necessary For Management of the Family's Real Estate Assets.*** Establish a FLP as a mechanism to properly manage, invest and control the real estate for the long-term benefit of the client's family. Having the family's real estate owned in a FLP is a way to lower the operating costs of managing that real estate.

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[53](...continued)
purpose, and not a business purpose.

[54] T.C. Memo 2008-74.

[55] T.C. Memo 2009-119.

6.3 ***<u>The FLP Allows Transferring of "Hard to Split Up Real Estate" to Children and Other Family Members</u>.*** Generally, real estate cannot easily be split as separate tenant-in-common interests among family members. Thus, a FLP avoids having to gift fractional interests in such real estate to family members. Where family members directly own real estate fractional interests as tenants-in-common problems can occur with a family member's death, divorce, or bankruptcy, or if there are creditor claims against the family member. Minor children owning real estate fractional interests can create title and legal authority problems on the sale of those real estate fractional interests. On the other hand, a FLP allows multiple ownership of real estate (in the form of limited partner interests) by family members, while avoiding these issues.

6.4 ***<u>The FLP Assists in Providing Protection From Creditors</u>.*** The FLP can assist to provide asset protection. For example, in California, the partner's creditor can obtain a charging order against the partner's FLP limited partnership interests.[56] However, the partner's creditor <u>cannot</u> obtain a direct attachment of the underlying FLP-owned real estate, nor force the FLP general partner to make distributions from the FLP to the partner. Furthermore, having multiple owners of the FLP discourages one particular partner's creditor from proceeding against that partner's FLP interest.[57]

6.5 ***<u>The FLP Provides Centralized Management Control of the Real Estate in the FLP General Partner</u>.*** The FLP provides for on-going centralized "control" by the FLP's general partner to manage the FLP's real estate. This protects younger family members[58] from being spendthrifts and provides a unified method for the family to control and invest their real estate assets.[59]

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[56] A discouragement for a creditor to obtain a charging order against a FLP limited partner interest is that the creditor then becomes taxable on the limited partner's share of the FLP income even if the FLP makes no distributions to that creditor. See Rev. Rul. 77-137, 1977-1 CB 178 where an assignee partner is taxed on its share of partnership income.

[57] One creditor protection device is to include in the FLP partnership agreement a provision stating that if there is an involuntary transfer of a partner's FLP interest to a creditor, that the FLP (or the other partners) would then have the option of purchasing such creditor's FLP interest at a defined purchase price with valuation discounts, which will normally require the creditor/partner to sell its FLP interest for less than that partner's proportionate share of the underlying FLP asset value.

[58] Not only does the FLP prevent younger family members from selling their FLP interests, but the FLP general partner can elect to reinvest the FLP's cash flow (and not distribute this cash flow to younger family members).

[59] Even though this FLP business purpose is very similar to that of using a trust to control a child's assets, a FLP offers more flexibility than does a trust.

6.6 ***The FLP Provides a Mechanism to Resolve Potential Family Disputes As to the Real Estate.*** Where there are potential family member disputes as to the real estate the FLP agreement can provide arbitration clauses to resolve family conflicts.[60]

6.7 ***The FLP Provides Protection in the Event of a Child's Divorce.*** The FLP provides protection should a family member's marriage dissolve. Through gifts and purchases, the FLP limited partner interests can be characterized as the sole and separate property of married children. It is difficult for a child to commingle the child's separate property FLP limited partnership interests with the child's community property. On the other hand, if real estate is owned directly by the child (rather than in a FLP), there is a greater likelihood allegations that the real estate was transmuted in whole or in part community property, and there is also a greater likelihood that the child's spouse will make a claim against real estate owned outright by a child in the event of a divorce.[61]

6.8 ***Can Include Rights of Buyback and First Refusal in a FLP.*** Rights of first refusal for partners who desire to sell their FLP interests, and even rights of purchase of FLP interests, can be included in the FLP's partnership agreement to prevent non-family members or non-lineal descendants from owning FLP interests. For example, in the event of a child's death, the other family members can be given the first right to purchase that deceased child's FLP interest.

6.9 ***The FLP Provides the Opportunity to Train Other Family Members to Manage the Family's Real Estate Affairs.*** The FLP offers the opportunity to train other family members to manage the FLP's real estate by training children and grandchildren in the FLP's real estate operations, and slowly bringing these other family members into working for the FLP's managing general partner.

7. GUIDELINES TO ASSIST CLIENTS IN FORMING AND OPERATING REAL ESTATE PARTNERSHIPS IN ORDER TO AVOID §2036

Recent Tax Court and Court of Appeals cases indicate the importance of following proper formalities in both forming and operating a real estate FLP. If the FLP is not properly operated, the

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[60] Since the FLP partnership agreement is an agreement among all of the partners, the partners can agree on behalf of themselves and their assignees to have any dispute resolved by binding arbitration. Also, a FLP partnership agreement can discourage frivolous lawsuits by family members by requiring that the loser of any lawsuit pay the prevailing family members' legal fees.

[61] Similar to the creditor protection devices discussed at paragraph 6.4, a provision can be included in the FLP agreement providing that a divorced partner's FLP interest can be purchased at a discounted purchase price should the child's spouse make a claim against such FLP interest (with the fair market value of the FLP interest defined in the FLP partnership agreement as considering all valuation discounts, thereby producing a lower purchase price).

client risks inclusion of the FLP's real estate in the client's federal taxable estate under §2036, as well as other IRS attacks.

Guideposts for clients to properly form and operate FLPs are discussed below:

7.1 ***Clients Forming FLPs Should Not Retain the Economic Benefits of the Real Estate Contributed to the FLP, or the Sold or Gifted FLP Interests***. If the client retains the economic benefits of the real estate transferred to the FLP, then the IRS will attempt to include that real estate in the client's gross estate under §2036(a)(1).[62] On the other hand, in ***Estate of Anna Mirowski*** where partnership formalities were observed and the parent did not retain the FLP's benefits or control over the FLP, then the Tax Court has held that the assets of the FLP will not be included in the deceased parent's gross estate under §2036.

Section 2036(a)(1) states that the value of the decedent's gross estate includes the value of all property which the decedent transferred (except in case of a bonafide sale for an adequate consideration in money or money's worth), of which the possession or enjoyment of, or the right in the income from, the property is retained by the decedent.

For example, in the second ***Strangi*** decision, known as "***Strangi II***"[63] the Tax Court held that the FLP's assets, which were transferred by the decedent to the FLP, were includable in the

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[62] See, for example, the Tax Court decision in ***Estate of Powell*** where death bed transfer. Also, see ***Rosen***, T. C. Memo 2006-115, where the assets which the client contributed to the FLP were included in the decedent's estate under §2036(a)(1) because the decedent retained the right to the enjoyment of those contributed assets for the decedent's life. In ***Rosen*** the decedent transferred substantially all of the decedent's assets to the FLP, did not retain enough assets for her day-to-day living expenses, and there were non-pro rata distributions made by the FLP.

[63] T. C. Memo 2003-145, *rem'd* by 89 AFTR 2d 2002-2977 (5th Cir. 2002). The Fifth Circuit Court of Appeals reversed the Tax Court's first ***Strangi*** opinion (known as "***Strangi I***") previously decided at 115 T.C. 478 (2000). This ***Strangi I*** Tax Court decision rejected the IRS's Chapter 14 arguments, IRS assertions on gift on formation, and lack of economic substance. The Fifth Circuit Court of Appeals reversed the Tax Court's ***Strangi I*** decision because the Fifth Circuit stated that the Tax Court had not considered the application of §2036.

Thus, in the second Tax Court ***Strangi*** decision (known as "***Strangi II***"), T. C. Memo 2003-145, the Tax Court applied both §§2036(a)(1) and (a)(2) to the FLP and held in favor of the IRS. The Fifth Circuit Court of Appeals then affirmed ***Strangi II*** at 96 AFTR 2d 2005-5230 (5th Cir. 2005). In this second Fifth Circuit Court of Appeals ***Strangi II*** decision, the Court of Appeals did not comment on the Tax Court's analysis under §2036(a)(2) in ***Strangi II***, but did affirm the Tax Court's ***Strangi II*** analysis under §2036(a)(1).

decedent's estate under §2036(a)(1). The Tax Court found that the decedent possessed the right to enjoy the income from the property which the decedent transferred to the FLP under an "implied agreement." The court based its ruling upon the fact that the decedent transferred 98% of the decedent's assets to the FLP, the decedent continued to occupy the decedent's personal residence without paying rent after transferring the residence to the FLP, the decedent's personal assets and the FLP's assets were commingled, the FLP made disproportionate distributions to the decedent, the decedent had access to the FLP's funds to pay the decedent's personal expenses, and the FLP was formed shortly before the decedent's death.[64]

7.2 ***<u>Do Not Pay Personal Expenses of Client or Other Partners From the FLP</u>***. The FLP should not pay the personal expenses of the client or any other FLP partner.

In the Ninth Circuit Court of Appeals decision in ***Bigelow***[65] the Court found an implied agreement by the decedent to retain the economic benefit of assets transferred to a FLP, where the FLP paid the decedent's debts. In ***Bigelow*** the debt, which was secured by the property transferred to the FLP, was <u>not</u> transferred to the FLP. Thus, the Court found that the FLP had repaid the decedent's debt despite the fact the FLP had no legal obligation to do so.

The IRS has successfully made the §2036(a)(1) argument to include the FLP's assets in the taxpayer's death, where the FLP paid the decedent's personal expenses, in ***Reichardt***[66] and ***Harper***[67].

[64] Additionally, the Tax Court in its ***Strangi II*** decision held that the decedent had the <u>power to designate</u> who would enjoy the income of the FLP and, thus, also applied §2036(a)(2) to include the FLP's assets in the decedent's gross estate. The Tax Court based its §2036(a)(2) holding upon the fact that the FLP partnership agreement gave the general partner the sole discretion to determine the FLP distributions, the decedent with the other partners could vote to dissolve the FLP, and the decedent with the other FLP corporate general partner shareholders could make distributions from the FLP. This ***Strangi II*** Tax Court's application of §2036(a)(2) has been criticized by commentators.

[65] In ***Bigelow*** no distributions were made to any other FLP partner before the decedent's death, partnership formalities were not followed, and payment were made by the FLP for the benefit of the decedent.

[66] 114 T.C. 144 (2000). In ***Reichart***, the Tax Court found that the decedent and his children had an implied agreement that the decedent could continue to enjoy the FLP's assets during the decedent's lifetime. After the transfer of property to the FLP, the decedent continued to enjoy the FLP's property and retained the right to income from the FLP's assets. Importantly, in ***Reichart***, there was a commingling of the FLP's assets with the decedent's personal funds, and the decedent's personal residence was also contributed to the FLP in which the decedent continued to live without paying

(continued...)

In a ***Estate of Concetta H. Rector***[68], the IRS included under §2036, the value of decedent's property transferred into a FLP where the decedent utilized the FLP's assets to pay the decedent's tax obligations, medical expenses and other personal expenses.

7.3 ***Do Not Make Cash Gifts From the FLP to Family Members***. In the 2009 Tax Court case of ***Estate of Erma Jorgensen***[69] the Tax Court found that the decedent retained the benefits of the FLP where the decedent used partnership assets to make significant cash gifts to her family members. After the decedent's death, the partnership then made principal distributions to pay the decedent's estate taxes and estate obligations.

7.4 ***Do Not Commingle FLP Assets With the Personal Assets of Any of the FLP Partners.*** None of the FLP partners should commingle their personal assets with the FLP's assets. Instead, the income and rents from the FLP's real estate should be deposited into the FLP's separate bank and brokerage accounts, and not into the client's personal account. If income is transferred directly from the FLP-owned real estate to the client's bank account (such as having real property rents paid to the client instead of to the FLP), then the IRS may assert that the client retained the "enjoyment" of the FLP's real estate under §2036(a)(1), thereby including the FLP's real estate in the client's taxable estate.

7.5 ***The FLP Should Make Timely Annual Distributions to its Partners in Proportion to Those Partners' Percentage Interests***. The FLP should make distributions to its partners in proportion to their percentage interests, and the FLP should not make preferential distributions to the client, nor make advance distributions to a client that are to be repaid to the FLP in later years. Preferably, the FLP distributions should be made at least annually. Some FLPs violate these distribution formalities by making disproportionate distributions to the parents where the parents need FLP assets for their personal living expenses, medical needs, or for an outside investment that the parents may wish to make.

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[66](...continued)
rent. Also, see ***Schauerhamer***, T. C. Memo 1997-242, for another similar §2036(a)(1) case.

[67] T. C. Memo 2002-121. In ***Harper***, the decedent established a FLP shortly before the decedent's death, then transferred substantially all of the decedent's assets to this FLP, followed by a transfer of FLP limited partner interests to the decedent's children. The Tax Court, in finding the application of §2036, found among other items that there was a delay in the decedent transferring assets to the FLP; there was a commingling of the decedent's assets with those of the FLP; and there were FLP distributions not in proportion to those specified in the FLP partnership agreement.

[68] T.C. Memo 2007-367.

[69] T.C. Memo 2009-66.

It is important that clients be disciplined to not make disproportionate distributions from the FLP, nor to receive loans or advances from the FLP.

7.6 ***It is Helpful If Other Family Members Are FLP Partners By Making Capital Contributions.*** It is helpful to show that the client's family members become initial FLP partners by way of gifts, sales of FLP interests, or preferably by having these family members contribute their own capital to the FLP. Having the client's children contribute the children's own capital to the FLP evidences that the FLP is a mutual business enterprise among the family members.[70]

7.7 ***It is Helpful if Different Family Members Are Represented By Different Attorneys***. In the FLP's formation (and in the FLP's ongoing operations) it is helpful to evidence the FLP's business purpose if there are arm's-length negotiations among the parents and children. Arm's-length negotiations can be evidenced, for example, by the parents and children each having their own separate attorneys represent them on their contribution of assets to the FLP.[71]

7.8 ***Do Not Have the Client's Personal Residence Owned in the FLP.*** Importantly, the client's personal residence should not be owned by the FLP. Since the client will be living in this personal residence, having the FLP own that residence allows the IRS to argue that the client improperly retained the "enjoyment" of that residence and the FLP's assets under §2036(a)(1).[72]

7.9 ***Preferably, Do Not Allow the FLP to Directly Pay the Client's Estate's Expenses or Estate Taxes on Death***. Preferably, the client's estate plan should contemplate that the client's estate's expenses and estate taxes will be paid from a source other than the FLP's assets.

(a) ***Cases That Taxpayers Lost***. If the FLP were to pay a deceased client's estate's expenses or estate taxes, then the IRS, as it did in ***Strangi II*** and ***Estate of Erma V. Jorgensen***[73], may assert that these payments represent the decedent's retention of the FLP's economic benefits, thereby including the FLP's assets in the deceased client's taxable estate under §2036(a)(1). In ***Estate of Erma Jorgensen***, the Tax Court held that the decedent retained the FLP's

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[70] See ***Estate of Schutt***, T. C. Memo 2005-126.

[71] See ***Estate of Stone***, T. C. Memo 2003-309.

[72] See, for example, ***Disbrow Estate***, T. C. Memo 2006-34.

[73] T.C. Memo 2009-66.

economic benefit where a substantial amount of the partnership assets was utilized to pay the decedent's pre-death and post-death obligations.[74]

(b) ***Cases That Taxpayer Won***. In the Federal District Court case of ***Keller***[75] the decedent formed several family limited partnerships to hold real estate and other investment assets. Upon the decedent's death, the decedent's estate borrowed monies from the FLP in order to pay the decedent's Federal estate taxes and the estate delivered back to the FLP a promissory note for the amount borrowed. The total amount of estate taxes borrowed from the FLP was $114,000,000 and the interest payment made on the promissory note amounted to $30,000,000. The interest income was reported by the FLP. The District Court found that the loan from the FLP was "actual and necessary" as an administration expense and allowed the interest deduction under Regulation §20.2053-3(a). The District Court indicated that the decedent's estate lacked sufficient liquid assets to pay "its necessary taxes and obligations without forcing the sale of its illiquid properties." Accordingly, the District Court held that the interest deduction claimed from the loan by the FLP to the estate was allowable as a §2053 deduction, and the Court did not find that the payment of these taxes (by this loan) would cause the inclusion of the FLP assets under §2036.[76] The Court emphasized that the decedent had left out of the FLP enough assets in the decedent's own name to comfortably live on for the remainder of the decedent's life and that the decedent did not need to rely upon the FLP's assets during the decedent's life.

(c) ***Preferably Have an Entity Other Than the FLP Make Loans to the Client's Estate to Pay the Client's Estate Taxes***. Despite the taxpayer victory in the ***Keller*** case (discussed above), the FLP should avoid loaning monies to the client's estate to pay the client's estate taxes, or the IRS, as it did in ***Erickson*** and ***Estate of Erma Jorgenson***, may assert that the decedent retained the enjoyment of the FLP's assets under §2036. If a loan from the FLP to the client's estate is made to pay the estate taxes (because there is no other source of funds to pay the taxes), then have a signed written promissory note collateralized by a pledge of the assets (such as its FLP limited

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[74] Also, see ***Erickson***, T. C. Memo 2007-107, where the Tax Court found that the decedent had retained enjoyment of the assets transferred to the FLP where those assets were available to pay the decedent's debts, expenses and estate taxes after the decedent's death. In ***Erickson*** substantially all of the decedent's assets were transferred to the FLP shortly before the decedent's death. The Tax Court in ***Erickson*** found that the FLP's disbursement of funds to the estate indicated an "implied" understanding that those funds would be available for the decedent, and that the monies that were disbursed to the decedent's estate (to pay the decedent's estate taxes and estate's expenses) were made at a time when no other FLP partners received monies from the FLP.

[75] 104 AFTR 2d 2009-6015 (S.D. Tex., 2009).

[76] The facts of ***Keller*** suggest a combined minority and lack of marketability valuation discount for the FLP interests in the 48% range.

partnership interests), and have regular payments of interest and principal paid on that promissory note.

7.10 ***The Client Should Have Liquid Assets Outside of the FLP to Pay the Client's Living Expenses***. The IRS may assert that the client has retained an economic benefit from the FLP under §2036(a)(1) if the client relies upon the FLP's assets for the client's living expenses. Instead, the client should retain enough liquid assets outside of the FLP in order to pay the client's living expenses for the remainder of the client's life. In other words, clients should not transfer to the FLP substantially all of their liquid assets.

7.11 ***Clients Should Follow Partnership Formalities in Operating the FLP***. The FLP should be operated in compliance with the terms and distribution provisions of the FLP's partnership agreement. In no event should the FLP assets be commingled with the client's personal funds.

7.12 ***Avoid Loans By the FLP to the FLP Partners***. Loans to partners by the FLP should be avoided. If loans are made by the FLP to the FLP's partners, then: (i) the repayment of principal and the payment of interest should be regularly paid back to the FLP; (ii) the loan should be evidenced by a signed written promissory note; and (iii) the promissory note should bear adequate interest.

7.13 ***Legally Title the Real Estate in the Name of the FLP, and Properly Maintain and Show This Real Estate on the FLP's Financial Statements***. The FLP real estate, along with other FLP assets, should be legally titled in the name of the FLP. In ***Hillgren***[77] the taxpayer lost under §2036(a)(1) where the real estate and its leases were not titled in the name of the FLP. In ***Estate of Sylvia Gore***[78], decided in 2007, the FLP's assets were included in the decedent's gross estate under §2036 in part because the transfer of assets to the FLP was not completed prior to the decedent's date of death.

Real estate transferred to the FLP should be treated as being owned by the FLP, and not treated as owned in the transferor's name. For example, inform the real estate's tenants in writing of the transfer of the real estate to the FLP and that future rent checks should be made payable to the FLP's name. All of the real estate's property and liability insurance for FLP-owned assets should show the FLP as the property owner.

7.14 ***The FLP Real Estate Should Be Contributed to the FLP Before the Limited Partner Interests are Gifted or Sold***.

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[77] T. C. Memo 2004-46.

[78] T. C. Memo 2007-169.

(a) ***Contribute Assets Before Gifting FLP Limited Partner Interests***. In the Tax Court case of ***Senda***[79] the taxpayer made contributions of assets to the FLP on the same day that the FLP partnership interests were gifted. Since the taxpayer could not prove that the contributions of property to the FLP were made before the taxpayer gifted FLP partnership interests to the taxpayer's family, the gifts were treated as gifts of the underlying FLP assets (and not gifts of FLP partnership interests). Thus, the taxpayer/donor was denied minority and lack of marketability valuation discounts.

Similarly, in the ***Shepherd***[80] case the Tax Court held that taxpayers contributions of property to an existing FLP was an indirect gift of such property to the FLP children partners. Based upon these cases, contributions of real estate to the FLP should be done prior to the gifting of FLP interests to family members, and FLP real estate contributions should be properly documented and the deed recorded.[81]

(b) ***Deed to Real Estate Before Gifting Partnership Interests***. In order to evidence that the partners have respected the formalities of the FLP, the partners should not delay the transfer of their real properties to the FLP. If the FLP's agreement recites that the real estate is transferred to the FLP on a specific date, then in fact that real estate should be transferred by deed to the FLP on that specified date.[82]

(c) ***Avoid IRS Step Transaction Attacks***. In ***Estate of Gross***[83] eleven days passed between the parents' transfers of publicly traded securities to the FLP and the parents' gift of FLP partnership interests to the children. The Tax Court recognized the FLP partnership interest valuation discount, and refused to apply the step-transaction doctrine.

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[79] T. C. Memo 2004-160 *aff'd* 433 F.3d 1044 (8th Cir. 2006). The decision was based upon an "indirect gift" of the underlying FLP assets by the taxpayer pursuant to §2501 and Reg. §25.2511-2(a).

[80] 115 T.C. 376 (2000), *aff'd* 89 283 F.3d 1258 (11th Cir. 2002).

[81] The issue of when assets are transferred to the FLP will be examined in the IRS's review of a FLP. See ***IRS Appeals Settlement Guidelines on Family Limited Partnerships and Family Limited Liability Corporations***, effective October 20, 2006.

[82] See ***Erickson***, T. C. Memo 2007-107, where the Tax Court found that the formalities of the FLP were not observed where the partners waited several months after the FLP's formation to transfer assets to the FLP.

[83] T.C. Memo 2008-221.

The step-transaction under one tax theory collapses formerly distinct steps in an "integrated transaction" in order to assess Federal tax liability on the basis of a "realistic view of the entire transaction."[84] The courts have come up with a number of standards to determine whether separate steps should be viewed together as comprising one transaction. In general, three alternative tests have been applied by the courts to determine if in fact a step-transaction has occurred: (i) the "binding commitment" test; (ii) the "end result" test; and (iii) the "interdependence" test. In ***Heckerman*** the Court applied the step-transaction because the gifts of the limited liability company membership interests were not delayed for a period of time after the funding of the limited liability company, and there was no evidence that the taxpayer bore any real economic risk that the limited liability company membership interests would change in value between the time between the funding of the limited liability company and the gifting of the limited liability company membership interests.[85]

7.15 ***<u>The FLP Should Maintain Separate Books and Accountings</u>***. The FLP should maintain separate books, separate brokerage accounts and separate checking accounts, prepare financial statements at least annually, and timely file state and federal income tax returns. Contributions of real estate to the FLP by the partners should be credited to the contributing partner's capital account. Similarly, FLP distributions should be debited to the distributee partner's capital account. Importantly, FLP distributions to its partners should be made in proportionate to each partner's FLP percentage interest.

7.16 ***<u>The FLP Should Charge Fair Value to Outside Persons for Such Outside Person's Use of the FLP's Real Estate</u>***. If a FLP's real property is used by another person (including a FLP partner), then that person must pay fair rental value to the FLP for the use of that real estate. Thus, whether the client, the FLP general partner or a FLP limited partner uses FLP real estate, the user must pay to the FLP the fair rental value for the use of that real estate.

7.17 ***<u>Have an Active Business in the FLP</u>***. It is helpful if the FLP should engage in an active business. Owning active real estate, such as rental apartment buildings or an office building, can be an active business. Other factors to evidence an active real estate business would be to have other active employees servicing the real property, a separate outside office, multiple properties, active development and/or repairing of real estate, and keeping regular books and records in a business fashion.

7.18 ***<u>Regular Meetings and Minutes</u>***. Although under California state law regular meetings of limited partners (or members of a limited liability company), and minutes of such

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[84] See the District Court case of ***Heckerman,*** 104 AFTR 2d 2009-5551 (D.C. Wa., 2009).

[85] The Federal District Court of the State of Washington again applied the step-transaction in the case of ***Linton***, 104 AFTR 2d 2009-5176 (D.C. Wa., 2009).

meetings, are not required, having meetings with written minutes helps evidence the FLP's business purpose. However, where a limited partnership (rather than a member-managed limited liability company) is utilized, clients must be cognizant of the rule that the limited partners should not participate in the management of the FLP in order to avoid having those limited partners taking on the FLP's general partner's liabilities.

7.19 ***Clients Should Consider Giving Up Direct Control Over the FLP's Real Estate***. This is probably the most controversial area in dealing with clients. Many clients want to retain "control" over how the FLP's assets are being managed. Remember that asking a client to give up control over the FLP may be inconsistent with that client's desire to direct the FLP's business and real estate investments.

The IRS successfully asserted in ***Strangi II*** that a client's management control over a FLP's general partner interest is a prohibited retained §2036(a)(2) power.[86] The Tax Court's ***Strangi II*** decision stated that the FLP assets were included in the decedent's taxable estate at death based in part upon the theory that the decedent indirectly retained the general partner's management powers, which was a prohibited retained §2036(a)(2) power. In ***Strangi II***, the decedent's retained management rights were based upon the decedent's family's control of the FLP general partner interest.[87]

However, the IRS lost on this §2036(a)(2) issue in ***Kimbell*** where the decedent had the right to remove the general partner and replace the general partner.[88]

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[86] Section 2036(a)(2) states that the decedent will have retained a §2036 power where the decedent has the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

[87] Interestingly, the ***Strangi II*** Tax Court decision rejected the IRS's holdings in several prior IRS Private Letter Rulings which stated that the ***Byrum***, 30 AFTR 2d 72-5811 (S. Ct. 1972), case applied to a limited partnership's general partner's powers so that the general partner, because of that general partner's fiduciary duties towards the limited partners and the limited partnership, would not have a retained §2036 power over the transferred limited partnership interests. See, for example, PLRs 9332006 and 9310039.

[88] The Fifth Circuit in ***Kimbell***, 93 AFTR2d 2004-2400 (5th Cir., 2004) vacated and remanded the District Court's decision, holding that the District Court erred in finding that family members could not enter into bonafide transactions and that a transfer of assets for a pro rata partnership interest lacked full and adequate consideration. In ***Kimbell*** the decedent, who was 96 years old, established a FLP two months before her death.

However, in ***Estate of Powell*** the Tax Court applied §2036(a)(2) where the gifting taxpayer and the other partners together could liquidate the partnership by unanimous agreement. Thus, the Tax Court included the partnership's assets in the taxpayer's taxable estate.

(a) ***Alternative of Having the Client Not Be the FLP's General Partner.*** One approach to avoid the adverse §2036(a)(2) tax result of ***Strangi II*** (and ***Powell***) is to have the client not be the FLP's general partner and also the client should not have the power to remove or replace that FLP general partner (or have any vote as to the partnership's liquidation).

Clients who are currently serving as general partners of their FLPs can sell their FLP general partner interests to their children and other family members. The reason to sell the client's FLP general partner interest for consideration is to avoid the §2035 three-year inclusion rule. For a client's transfer of a FLP general partner interest (or a limited partner interest) during the client's lifetime, §2035(a) may apply to bring back within the client's gross estate FLP interests which are transferred within three years of the client's date of death.[89]

(b) ***Alternative to Have Other Family Members Serve as the FLP General Partner.*** Where the client's family members (such as the client's children) are left as the sole FLP general partners, then the FLP partnership agreement could state that the general partner has fiduciary duties towards the limited partners, and that the limited partners have no management rights over the FLP's affairs.

(c) ***Alternative to Use a Trust as the FLP General Partner***. The FLP general partner may be a trust with the client's children as trust beneficiaries and someone other than the client serving as trustee. It has been suggested that the client could retain removal and replacement property over the trustee of a trust that is the FLP general partner as long as the newly appointed trustee is not subservient to the client's wishes.

(d) ***Preserve the Fiduciary Duties of the FLP General Partner.*** It is preferable that the client/donor not retain control over the FLP's distributions either directly as the FLP general partner or indirectly by being able to direct family members who are the FLP general partners, in order that the IRS does not argue that the client retained control over the FLP distributions in a "non-fiduciary" capacity under §2036(a)(2). Some ideas to try to counter this potential IRS argument is for the FLP's partnership agreement to state that the FLP's general partner must exercise all of their

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[89] Section 2035(a) states that if a decedent dies within three years of transferring property, or relinquishing a right relating to such transferred property which would have triggered estate tax under certain specified Internal Revenue Code sections (including §2036), had the transferor died possessing such right, then the underlying assets are brought back into the decedent's gross estate. One way to avoid §2035(a) is to make a "bonafide sale for an adequate and full consideration in money or money's worth" of the FLP interests under §2035(d).

powers in compliance with state fiduciary law standards, that all FLP partners receive distributions only in proportion to their FLP percentage interests, and preferably that distributions shall be made at specific time intervals (such as annually) to each FLP partner.

7.20 ***Preserving the General Partner's Fiduciary Duties Towards the Limited Partners***. Under this planning the FLP's partnership agreement does not waive state law imposed fiduciary duties of the FLP's general partner towards the limited partners.

The general partner's fiduciary duties being preserved arguably assists the client who remains a FLP general partner, to avoid IRS attacks under §2036(a)(2).

Preserving state law imposed fiduciary duties was the basis for the landmark taxpayer victory in the U.S. Supreme Court case of ***Byrum***[90], a case in the §2036 corporate stock area. After the 1972 ***Byrum*** decision, Congress amended §2036 in the corporate context by adding §2036(b) which causes inclusion of corporate stock in a transferor's gross estate if voting stock of a controlled corporation is transferred for less than full and adequate consideration, where the transferor retains the right to vote that stock. However, Congress has never amended §2036 in the partnership or limited liability company context. Thus, taxpayers could argue that the Supreme Court's ***Byrum*** rule that fiduciary standards trump §2036(a)(2) should be applicable to FLP general partners. Note, however that the Tax Court may reject this argument based upon the ***Estate of Powell*** decision.

7.21 ***Structure the Transfer of FLP Limited Partner or General Partner Interests for "Adequate and Full Consideration" in Order to Avoid §2036(a)***. Section 2036(a) by its terms does not apply to a transfer where the transfer is a bonafide sale "for an adequate and full consideration in money or money's worth." Arguably, this §2036 transfer exception applies where each family member contributes assets to the FLP and receives back in return FLP interests which are proportionate to the fair market value of their contributed assets.

7.22 ***The FLP Should Be Formed and Funded With Real Estate Well Before the Client's Date of Death.*** The IRS will challenge FLPs formed shortly before a client's date of death under a "death bed partnership formation" theory and allege that the FLP is simply a substitute for a testamentary transfer. This IRS challenge is especially likely to occur where the transferring client, on the date of the FLP's formation, is very elderly, in poor health, or terminally ill.

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[90] ***Supra***, note 106. The Supreme Court in ***Byrum*** held that the decedent shareholder did not retain a prohibited §2036(a)(2) power because of the fiduciary duties owed by the decedent as the controlling shareholder to the corporation. In ***Byrum*** the decedent transferred stock to a trust for the decedent's children's benefit, but the decedent retained the right to vote such stock which represented 71% of the voting power. The Supreme Court stated that the decedent as controlling majority shareholder had a fiduciary duty not to misuse his power by promoting his personal interests at the expense of corporate interests.

In the ***Estate of Anna Mirowski***[91] assets were transferred to a limited liability company shortly before the decedent's death. The Tax Court held that the limited liability company was valid where the assets were properly credited to capital accounts and the decedent's subsequent death was unexpected. However, see the taxpayer losing under §2036 in ***Estate of Powell*** were assets were transferred to the partnership right before the client's death.

Accordingly, FLPs should be formed and funded as far in advance as possible prior to the client's date of death and should establish a history of operation.

7.23 ***The FLP Interests Should Be Structured as a "Present Interest" if the Goal is to Qualify for the Federal Gift Tax Annual Exclusion***. For a gifted FLP limited partner interest to qualify for the annual gift tax exclusion under §2503(b) (currently $15,000 per donee per year, or $30,000 in the aggregate per donee per year for two spouses donors), the limited partner interests must be a present interest (and may not be a future interest).[92]

In ***Hackl***[93] the Tax Court held that a gifted limited liability company membership interest did not qualify as a "present interest" because the donee could not require distributions from the limited liability company, the gifted membership interest could not be transferred without the manager's consent, and the donee could not cause the limited liability company's liquidation. Although ***Hackl*** was a family limited liability company case, this case's tax principles also apply to FLPs.

In order to avoid the adverse gift tax result of ***Hackl***, to qualify for the gift tax annual exclusion the FLP partnership agreements should require annual FLP distributions, provide that the limited partners may sell their FLP limited partner interests without the consent of the general partner, and allow the FLP's liquidation only pursuant to state law.[94]

7.24 ***Clients Should Obtain a Qualified Appraisal of the Gifted FLP Interests***. See paragraph 5.5, above, for the importance of obtaining a qualified appraisal. To have the federal gift

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[91] T.C. Memo 2008-74.

[92] A "present interest" is defined under Reg. §25.2503-3(b) as an "unrestricted right to the immediate use, possession or enjoyment of property or the income from property."

[93] 118 T.C. 279 (2002), *aff'd* 92 AFTR 2d 2003-5254 (7th Cir. 2003).

[94] It has been suggested a present interest would be created if the donee limited partner is allowed to withdraw from the FLP and receive monies for their FLP interest (or to be able to require the FLP to dissolve and liquidate). However, granting such rights to the FLP's limited partners could reduce the minority and lack of marketability valuation discounts.

tax statute of limitations commence running, a qualified appraisal of the FLP interests should be attached to the gift tax return filed with the IRS. Regulations §301.6501(c)-1(f)(2) set forth the required items to include in a qualified appraisal, such as a description of the appraisal process employed and the specific reasoning of the valuation.

7.25 ***Should the FLP General Partner Receive a Management Fee***? In operating the FLP, it is a good practice for the general partner (who is not the donor client) to receive reasonable compensation for that general partner's management services rendered to the FLP. Having a management fee paid to the general partner who provides services to the FLP evidences an arm's-length relationship in the FLP's operation.

A management fee will be deductible by the FLP for income tax purposes and will be taxed to the recipient general partner at ordinary income rates. Additionally, the management fee is self-employment income to the recipient FLP general partner subject to FICA taxes on compensation and self-employment income up to the social security wage base for the applicable year, plus the Medicare hospital insurance tax.

Under the family partnership income tax rules of §704, if a FLP interest has been transferred by gift or where a family member has purchased a FLP interest from another family member, then the donor (which includes a person from whom another family member has purchased an interest) should receive reasonable compensation for their services to the FLP. The balance of the FLP's income should then be allocated proportionately according to each partner's capital account balance in order to avoid reallocation of the income under the family partnership rules of §704(e).

7.26 ***Should the FLP Continue to Be Operated After the Death of the Decedent***? It is helpful if the FLP continues to be operated after the client's death for the benefit of the client's children and other family members who are the continuing partners. The FLP's continuation evidences that the FLP did, in fact, have a business purpose to continue the family's business affairs and to preserve the family's assets. Also, continuing the FLP helps evidence a lack of marketability discount.

8. CHAPTER 14 AND FLP ISSUES

Congress in 1990 enacted Chapter 14 of the Internal Revenue Code (§§2701-2704) to address perceived abusive estate freeze transactions. Estate freeze transactions were either partnership or corporate structures under which a person retained income and management rights of transferred assets, while attempting to transfer the appreciation in value of those assets to other family members. For example, in the FLP area, the parent would receive a preferred interest in the FLP, while the children would receive interests in all future appreciation of the FLP assets and did not participate in FLP management. The main issue with estate freezes (in the FLP area or otherwise) was whether the parents and children received adequate consideration in exchange for what they contributed to the FLP. Because of taxpayer abuses in valuing the parents' preferential rights where the parents would contribute all of the assets to the entity (such as into a FLP), Congress enacted Chapter 14. The IRS in past court cases generally has not been successful in attacking FLPs under the Chapter 14 provisions.

8.1 ***IRS Attacks of FLPs Under §2703(a)***. The IRS has attacked FLPs by claiming that gifts of FLP interests by parents to children should in fact be treated as gifts by the parents to their children of the underlying FLP assets and that the FLP's partnership agreement should be treated as a restriction on the right to sell or use the underlying FLP assets, which partnership agreement should then be ignored under §2703. This IRS §2703 argument is that the FLP interests should be valued without regard to the restrictions imposed by the partnership agreement to the use of the FLP's underlying assets.

The IRS failed in this §2703(a) attack on FLPs in the Tax Court case of ***Strangi I***[95]. In ***Strangi I*** the IRS unsuccessfully argued that the FLP partnership agreement should be ignored as a prohibited §2703(a)(2) restriction on the underlying partnership property.

8.2 ***IRS Attack of FLPs Under §2704(b)***. The IRS has generally been unsuccessful in arguing that §2704(b) can be used to disregard the FLP's restrictions on liquidating the FLP's property for valuation purposes.

Section 2704(b) provides that if there is a transfer of an interest in a partnership to or for the benefit of the transferor's family, and immediately before the transfer the transferor and members of the transferor's family control that entity, any restrictions which limit the ability to liquidate the partnership (referred to as an "applicable restriction") will be disregarded for valuation purposes if: (i) that restriction lapses in whole or in part after the transfer; or (ii) the transferor or members of the transferor's family, alone or collectively, have the right to alter that restriction. In other words, under §2704(b) the FLP interest is valued without taking into account the applicable restriction (thereby increasing the transferred FLP limited partnership interest's value). Importantly, the §2704(b) provisions do not apply to commercially reasonable restrictions required by third party financing or as to any applicable restriction imposed by state or federal law.

Accordingly, the negative tax results of §2704(b) do not apply if the FLP cannot be unilaterally liquidated by the client (and their family) under that FLP's governing state law.

The IRS's §2704(b) argument was rejected by the Tax Court in ***Kerr***[96] where the IRS argued that FLP restrictions on liquidating FLP assets were more restrictive than the state law (in ***Kerr***

[95] See ***Strangi I, supra***.

[96] 113 T.C. 449 (1999), *aff'd* 89 AFTR 2d 2002-2838 (5th Cir. 2002).

Texas law applied) default provisions. The ***Kerr*** court found that §2704(b) does not apply to the transfer of FLP limited partner interests from parents to their children because the FLP restrictions were no more restrictive than the default state law restrictions. Similarly, in the first ***Harper***[97] Tax Court case (a California case the IRS later won on other issues) the Tax Court found that the FLPs agreement's terms were no more restrictive than state law and that §2704(b) did not apply.

The lesson to be learned from these cases is that the FLP's agreement should be structured so that the liquidation restrictions are no more restrictive than those of the applicable state law.

9. TRANSFERRING THE CLIENT'S REAL ESTATE TO YOUNGER FAMILY MEMBERS BY: TRANSFERRING OPPORTUNITIES; AND COMBINING FLPS WITH GRATS AND DEFECTIVE INCOME TRUSTS

Clients may desire to retain their real estate in their own name in order to get a step-up in income tax basis upon the client and client's spouse's death. However, if that the client wants to, in fact, transfer the client's real estate to the client's children and grandchildren then the client can consider several techniques which are discussed below.

The simplest technique to transfer real estate to children and grandchildren is to create a family limited partnership in which the children and grandchildren (or trusts for their benefits) are limited partners and the client has this partnership purchase a real estate opportunity that the client becomes aware of. The children and grandchildren can receive their capital to invest in the partnership by the client making loans to the children and grandchildren, and the children and grandchildren then investing these loaned monies for partnership equity interest.

Another way to transfer real estate to the children and grandchildren would be to utilize a family partnership combined with either a Grantor retained annuity trust (sometimes known as a "GRAT") or to utilize a defective income trust. Both of these tax planning techniques are described below.

The use of a GRAT and a defective income trust allows the client (the parents) to transfer real estate to younger family members at reduced or no estate and gift tax cost. The real estate is first contributed to a FLP and then such FLP partnership interests are transferred to younger generations by the use of GRATs or defective income trusts.

9.1 ***Use of GRATs to Own Real Estate FLP Interests***. A GRAT allows a client/grantor to make gifts of real estate at no gift or estate tax cost to younger family members. In a GRAT the client/grantor retains a fixed annuity (from the trust) for a term of years with the annuity paid to the

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[97] T. C. Memo 2000-202. This was the first ***Harper*** case. In the second ***Harper*** case at T. C. Memo 2002-121 the taxpayer lost on the §2036(a) issue.

client no less often than annually, and with the trust remainder interest passing to children or other family members. The remainder interest can go outright to these family members or remain in a trust for those family members' benefit.

(a) ***<u>The GRAT Annuity Must Qualify Under §2702(b)</u>***. The GRAT annuity (which is paid each year to the client/grantor) must be a "qualified interest" under §2702(b). Otherwise the GRAT remainder interest's value would be equal to the entire value of the assets gifted to the GRAT, with the client's retained annuity being valued at zero dollars. On the other hand, if the GRAT qualifies under §2702(b), then the value of the client/grantor's retained annuity interest is <u>not</u> valued at zero dollars, but instead is determined by using the actuarial value of that annuity interest calculated under §7520. Thus, the value of the qualifying GRAT's remainder interest for gift tax purposes is calculated by subtracting the value of the client/grantor's retained annuity interest from the GRAT's assets' value.

The GRAT must be an irrevocable trust. Additionally, there are numerous technical requirements for the GRAT to qualify under §2702 which are beyond the scope of this article.

(b) ***<u>The GRAT Must Pay an Annuity to the Grantor Each Year</u>***. The annuity may be stated as either: (i) a fixed dollar amount paid to the grantor each year; or (ii) a fixed percentage of the GRAT's asset's <u>initial</u> value prior to the grantor each year.[98] Where the percentage of the initial value approach is utilized, that percentage amount remains the same each year.

(c) ***<u>All of the GRAT's Income is Taxed to the Grantor</u>***. All of the GRAT's income is taxed to the grantor under §677. Therefore, the client/grantor is taxed on all of the GRAT's income even if the GRAT's income is greater than the annuity paid to the grantor. The income taxes on the GRAT's income may be paid by the client/grantor, and the grantor's payment of the GRAT's income taxes is <u>not</u> a gift to the GRAT's remaindermen.[99]

(d) ***<u>Using the Walton GRAT to Produce a Zero-Dollar Gift</u>***. The ***Walton***[100] case allows the GRAT to be structured so that the remainder interest has a zero gift tax cost. This results from the fact that the GRAT annuity can equal the entire value of the property transferred to the

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[98] If the GRAT annuity is defined as being a percentage of the initial value of the GRAT's assets, then the GRAT must contain a requirement that if the GRAT trustee incorrectly values the GRAT's assets, an adjustment must be made to the GRAT annuity due to such incorrect valuation. See Reg. §25.2702-3(b)(1).

[99] The payment of income taxes by the grantor is <u>not</u> taxable as a grantor gift to the trust under Rev. Rul. 2004-64.

[100] 115 T.C. 589 (2000), IRS *acq.* in Notice 2003-72, 2003-44 IRB 964.

GRAT. Under ***Walton*** the grantor can retain the annuity for a term of years, which annuity is paid to the grantor/client's estate even if the grantor/client dies and does not survive the full term of the annuity. Thus, under ***Walton*** the annuity period can be presumed actuarially longer, thereby reducing the value of the GRAT's remainder interest.[101]

(e) ***Grantor Must Survive GRAT Annuity Term For GRAT To Produce The Desired Tax Results***. The grantor/client must survive the GRAT annuity term in order for the GRAT to produce gift and estate tax benefits. If the grantor dies before the end of the GRAT's annuity term, then a portion of the GRAT's assets are included in the grantor/client's gross estate for federal estate tax purposes.[102] The portion of the GRAT's principal that is included in the deceased grantor's gross estate (for Federal estate tax purposes) is the portion of the trust principal necessary to provide the grantor/decedent's retain annuity, as determined under Regulation §20.2031-7 (which is the valuation of annuities).[103] The portion of the trust's principal included in the grantor/decedent's Federal gross estate under §2036 may not exceed the fair market value of the GRAT's principal on the date of the grantor's death.[104] Therefore, where the GRAT is payable for a specified number of years (and not for the grantor's life), if the grantor unexpectedly dies during the GRAT term a portion of the GRAT principal will be included in the grantor's Federal gross estate under §2036(a).

> **Example: Grantor transfers $100,000 to a GRAT. The GRAT provides for an annuity to the grantor for 10 years, and if the grantor dies during the GRAT annuity term, then the annuity would continue to be paid to the grantor's estate for the balance of the 10-year term. If the grantor dies before the end of the 10-year term, then the portion of the trust principal included in the grantor's Federal gross estate under the Regulations is calculated as follows: Assume that on the grantor's date of death the value of the trust's principal is $300,000 and a §7520 interest rate is 6%. The amount of corpus with respect to which the grantor retains the right to the income, and thus the amount included in the grantor's Federal gross estate under §2036 retained life estate rules is the amount of principal necessary to yield the annual annuity payment to the**

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[101] In structuring the GRAT as a "***Walton***" GRAT, the GRAT annuity will be for a fixed term, and if the grantor should die during this fixed term, the annuity amounts must continue to be paid to the grantor's estate.

[102] The annuity is a retained income interest by the grantor under §2036. If §2036 were to apply, any gift tax exclusion amount is credited back to the grantor.

[103] See Reg. §20.2036-1(c)(2)(i).

[104] See Reg. §20.2036-1(c)(2)(i).

grantor (without reducing or invading principal). In this case, the formula for determining the amount of principal necessary to yield the annual annuity payment to the grantor is: annual annuity divided by the §7520 interest rate equals the amount includable under §2036. In applying the IRS actuarial tables, the amount of principal necessary to yield the annual annuity is $205,540 (based upon the annuity tables at 6% interest). Thus, $205,540 is included in the grantor's Federal gross estate under §2036(a)(1). [See Regulation §20.2036-1(c)(2)(iii), example 2.]

(f) ***GRATs Do Not Qualify For the Gift Tax Annual Exclusion***. The GRAT remainder interest cannot qualify for the gift tax annual exclusion under §2503(b), since the remainder interest is a "future" interest.

(g) ***GRATs and the Generation-Skipping Tax***. GRATs are generally not effective for generation-skipping tax planning. The reason is that the estate tax inclusion period (known as "ETIP") under §2642(f) prohibits allocating the GST exemption during the time period during which the GRAT property is included in the grantor's gross estate. Therefore, the generation-skipping transfer does not occur until the GRAT remainder interest passes to the remainder persons when the annuity terminates. The result is that the GST exemption cannot be allocated until the annuity terminates, resulting in the GST tax exemption being based upon the GRAT's asset value at the time of termination.[105]

(h) ***Transferring Real Estate Tax Free By Using FLPs With GRATs***. GRATs work ideally with high yielding assets which appreciate in value. The lower the federal §7520 interest rates, the more favorable the result produced by the GRAT to reduce the client's gift and estate taxes. This is due to the fact that GRATs will produce the greatest gift tax benefit for those contributed assets that have a yield greater than the §7520 interest rate. (The §7520 interest rate in October 2018 was 3.4%.)

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[105] One tax planning idea to qualify for a current GRAT valuation for the GST exemption when the GRAT is funded is to have the GRAT remainder interest transferred by the GRAT remainder beneficiary to another trust for the grandchildren's benefit and have the GST exemption allocated to that trust transfer.

Another tax plan is to use a funded defective income trust (instead of using a GRAT) and then to allocate the GST exemption to the defective income trust which would result in such defective income trust having an inclusion ratio of zero. Thus, the sale of property to a defective income trust (which is also funded in part with gifted assets) in exchange for a promissory note allows the use of the GST exemption upon the funding of the trust.

A FLP enhances the ability for parents to use GRATs to transfer real estate to their children gift tax free. With a FLP it is possible for the GRAT to earn more than the §7520 earnings rate, thereby transferring more real estate to the GRAT beneficiaries gift tax free.

When a client uses a real estate FLP limited partner interest as the property transferred to the GRAT, the value of this gifted FLP limited partner interest can be discounted, thereby increasing the yield to the GRAT remainder interest, which in turn allows for the transfer of greater amounts (in the form of the GRAT remainder interest) to the client's children. Thus, because of the discounted FLP interests the value of the GRAT's remainder interest is lowered.

> **Example: Assume that a 60-year old client sets up a FLP to which that client contributes $1,000,000 of value of real estate (assume not encumbered by any debt) in exchange for a 75% FLP limited partner interest. Such contributed real estate outside of the FLP produced a 6.5% return (or $65,000 per year). Assume also that other family members contribute assets (could be real estate or securities) to the FLP in proportion to a 25% FLP interest which they receive back in the form of general and limited partner interests, which contributed assets also yield this same 6.5% return.**
>
> **Assume that the client's FLP limited partner interest (which the client received for the client's $1,000,000 contribution to the FLP) is valued with a 43% valuation discount for a minority interest and lack of marketability. Therefore, the value of the client's 75% FLP limited partner interest is $570,000 ($1,000,000 less a 43% valuation discount). Since this 75% ($570,000 valued) FLP limited partner interest still produces $65,000 of income each year, the client's 75% FLP limited partner interest now has an 11.4% yield after valuation discounts ($65,000 ÷ $570,000 = 11.4%).**
>
> **Under the GRAT actuarial tables (assuming a §7520 interest rate of 2.8%), the 60-year old client's 75% limited partner interest in the FLP (which is valued at $570,000 and produces an 11.4% yield) results in a GRAT remainder value of zero dollars where the GRAT annuity term is 11 years and pays the grantor a $65,000 annuity each year. Thus, this GRAT's remainder interest is transferred tax free to the children (assumes client lives the full 11 years).**

To achieve these valuation discounts, the GRAT should not be funded with the controlling general partner interest of the FLP, since such FLP interest would not have a minority or lack of control discount. Instead, consider having the FLP general partner interest owned by another trust for the children's benefit with an independent trustee.

9.2 ***Have a Defective Income Trust Purchase Real Estate FLP Interests***. An installment sale of a limited partner's FLP interest to a grantor trust (sometimes referred to as an "intentionally defective income trust") can enable a client to transfer large amounts of real estate to younger generations at no gift or estate tax cost.

A defective income trust is an irrevocable grantor trust under which the trust's income and deductions are allocated to the grantor for federal income tax purposes. The parent first transfers their real estate into the FLP. The parent/grantor then sells their FLP limited partnership interests to this grantor trust and receives back an installment promissory note. Since the client/grantor and the defective income trust are treated as the same taxpayer for income tax purposes, there is no sale for income tax purposes and the sale to the trust is instead treated as a non-income tax event.[106] The client/grantor is treated as the "owner" of all grantor trust items for federal income tax purposes and, as such, all of the defective income trust's income, deductions and credits are attributable back to the grantor/client.

The fact that the grantor trust's income and deductions are reported on the grantor's federal and state income tax returns and the grantor then pays the income taxes on the trust's income, is not a gift for gift tax purposes under Rev. Rul. 2004-64.[107] Thus, even though only the grantor's children are trust beneficiaries, the grantor can still pay the trust's income taxes and not have such income tax payments treated as a gift. By the fact that the client/grantor pays the trust's income tax burden (and not the children), further shifts assets away from the grantor (in the form of income taxes paid) to the grantor trust, and benefits the children.

The grantor trust is irrevocable for gift and estate tax purposes so that upon the grantor's death the trust's assets are not included in the grantor's taxable estate.

The grantor trust taxes its income to the grantor by "intentionally" violating one of the income tax grantor trust rules under §§671 through 675 of Subchapter J of the Internal Revenue

[106] See Rev. Rule 85-13, 1985-1 CB 184, where the IRS held that a transfer of assets to a grantor trust in exchange for the grantor's installment promissory note is not recognized as a sale for federal income tax purposes. Also, the IRS ruled in PLR 200434012 that no gain is recognized for income tax purposes upon the sale of assets to a grantor trust.

[107] Under Rev. Rul. 2004-64 the reason that the payment of income taxes by the grantor is not a gift to the trust beneficiaries is that the grantor has the legal obligation under subchapter J of the Internal Revenue Code to pay the trust's income taxes, and therefore such grantor's tax payment cannot be a gift.

Code. For example, the grantor could be given the power to substitute assets to the trust of equal value in a non-fiduciary capacity under §675.[108]

(a) ***The Installment Promissory Note Should Bear Interest At Least Equal to the AFR Rate***. The client's FLP limited partner interests are then sold to this grantor trust in exchange for an installment promissory note which has an interest rate at least equal to the applicable federal rate ("AFR") under §1274.[109] Since current AFRs have been very low, sales of FLP interest to grantor trusts have been attractive from a tax standpoint.

The AFR interest rate for a grantor trust will generally be lower than the §7520 rate for a GRAT.[110] Thus, a grantor trust will generally produce a lower interest cost for the trust beneficiaries than would a GRAT.

(b) ***Promissory Note Must Be Bonafide***. To evidence that the installment promissory note is a bonafide debt instrument for tax purposes, the promissory note should be secured and there should be a fixed schedule for the promissory note's repayment. If the promissory note is not a bonafide note, then the IRS may attempt to reclassify the note as equity or may allege

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[108] See §675(4)(C). The defective income trust should state that this power of substitution of assets is being held and exercised without any fiduciary duty of the grantor towards any beneficiary with respect to this power to exercise or to not exercise. A grantor's retained power, exercisable in a non-fiduciary capacity, to acquire property held by the trust by substituting property of equivalent will not, by itself, cause the value of the trust corpus to be includable in the grantor's gross estate for Federal estate tax purposes under § 2036 provided: (i) the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of the power that the properties acquired and substituted are in fact of equivalent value; and (ii) the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. See Rev. Rul. 2008-22.

[109] There are three AFR interest rates. The first AFR rate is for promissory notes payable on demand or after a term of no more than three years (the so-called "short-term AFR rate"). There is a second AFR rate for promissory notes for a term of more than three years but no more than nine years (the so-called "mid-term AFR rate"). There is the third AFR rate for promissory notes with terms over nine years (the so-called "long-term AFR rate").

[110] The reason the §7520 interest rate is generally higher than the AFR rate is that the §7520 rate is 120% of the mid-term AFR rate rounded to the nearest even 2/10ths of 1%. Accordingly, the §7520 will always be higher than the mid-term AFR rate. It is possible for the §7520 rate to be lower than the short-term AFR or long-term AFR rate. However, this is unlikely to occur.

that the promissory note simply represents the grantor's retention of the economic benefits of the FLP under §2036.[111]

The grantor trust should have additional assets (other than solely the trust's purchased FLP limited partner interest) in the form of other non-sold assets or personal guaranties of the trust beneficiaries in order to evidence that the promissory note was a commercially reasonable loan. Additionally, by having sufficient assets in the trust (or guaranties of the promissory note under some tax theories) avoids the IRS claim that the transaction should be characterized as a gift with the grantor retaining an income interest under §2036 with the resulting inclusion of the trust's assets in the grantor's estate.[112]

Thus, the grantor trust should have assets (in addition to the sold FLP limited partner interests) or a personal guaranty of the trust beneficiaries. A personal guaranty arguably could be utilized in lieu of (or combined with contributing assets) in order to have non-sold asset value in the trust at least equal to 10% of the value of the promissory note.[113] The person who signs the guaranty should have the necessary solvency to make payments on the guaranty. There is <u>no definitive tax authority</u> as to how much value of other assets the grantor trust must have (or whether a personal guaranty can be utilized) in order for the promissory note to be recognized as bonafide. Arguably the trust's other unsold assets should equal to at least 10% of the principal amount of the installment promissory note.[114]

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[111] If §2701 applies, the client has retained an "applicable retained interest" and the promissory note would have zero-dollar value, creating a potential taxable gift on the value of the FLP interests transferred to the grantor trust.

[112] See, for example, ***Fidelity Philadelphia Trust Co.***, 356 U.S. 274 (1956), where the Supreme Court held that the <u>debt is bonafide</u> if the debt's payment is not based upon the amount of income produced by the trust; the debt payment obligation is not charged to the transferred property; and the debt is an obligation of the transferee (i.e., the trust).

[113] See PLR 9515039.

[114] In PLR 9535026 the IRS approved this installment sale of assets to a grantor trust having an asset value equal to 10% of the value of the other assets sold to the grantor trust. The reasoning is that without a minimum 10% trust corpus from non-purchased assets the promissory note payments are effectively being satisfied solely out of the property being sold to the trust and that sold property's earnings. In such event the seller's payments from the promissory note are effectively limited to the cash flow of the assets being sold, and therefore those trust assets should be included in the seller's estate under §2036 (arguably the amount included in the seller's estate may be reduced under §2043 by the outstanding amount of the promissory note then owed by the trust).

The promissory note's terms should be complied with by the trust's timely payment of principal and interest to the grantor.

(c) ***No Taxable Gain Upon the Sale of FLP Interests to a Grantor Trust***. Since the client/grantor and the grantor trust (which is the purchaser of the FLP limited partnership interest) are treated under Rev. Rul. 85-13 as the same taxpayer for income tax purposes no gain or loss is recognized on the sale of real estate FLP partnership interests to the grantor trust (in exchange for the trust's installment note) nor is any of the interest paid on the installment note taxed to the grantor or deductible by the grantor trust.[115]

(d) ***No Requirement That Grantor Survive the Term of the Promissory Note***. The main tax advantage of a grantor trust sale over a GRAT is that in a grantor trust sale the client does not have to survive the term of the grantor trust's installment promissory note to obtain the estate tax advantages. If the grantor/client dies before all of the payments are made on the installment note then the value of the unpaid installment note is includable in the client's gross estate for estate tax purposes.

(e) ***Tax Uncertainties Upon the Death of Grantor***. An area of tax uncertainty for sales to grantor trusts is that if the grantor dies before the installment note is paid in full to the client/grantor, what happens to the promissory note's deferred gain? Is the installment note's gain triggered on the date of the client's death? Is there a step-up in the Grantor trust's FLP's partnership interest's tax basis on the client's date of death without triggering any gain? The IRS in Chief Counsel Advice Memorandum 200923024 indicated that the authority under Regulation 1.1001-2(c), example 5, where there was a taxable event when a grantor trust ceased being a grantor trust (and thus a taxable event occurred) was a narrow rule that only affected inter vivos lapses of grantor trusts. This Chief Counsel Advice Memorandum indicates that generally the death of the owner of a grantor trust is not treated as an income tax event.

From a tax planning standpoint it is best that the installment promissory note is paid in full to the client before the client's death for, among other reasons, that the IRS cannot argue that the promissory note represents the client's retention of a prohibited income interest under §2036.

(f) ***GST Exemption and Defective Income Trusts***. No amount of the GST exemption needs to be allocated to the grantor trust if the FLP limited partner interests are sold to the trust for these partnership interest's fair market value. However, if assets are initially gifted to the grantor trust, then these gifted assets should be allocated the GST tax exemption amount on the Form 709 equal to the value of this gift.

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[115] Furthermore, the client/grantor may pay the income taxes generated by the FLP interest owned by the Grantor trust without such income tax payments becoming a gift to the client's children, under Rev. Rul. 2004-64.

(g) ***<u>Example of How to Transfer Real Estate Tax Free By Using a Grantor Defective Income Trust With a FLP</u>***.

> **<u>Example</u>: Assume that a client in June 2009 transfers real estate (with a fair market value of $1,000,000) to a FLP. The client receives back a $1,000,000 face value (before valuation discounts) a 75% FLP limited partner interest which produces $65,000 per year. Assuming a 43% valuation discount applies to the 75% FLP limited partnership interest thereby producing a discounted value of $570,000 for this FLP limited partnership interest (which produces a yield of 11.4%, or $65,000, per year).**
>
> **Assume that this $570,000 FLP limited partner interest is then sold by the client to a grantor trust in exchange for an installment promissory note with a face amount of $570,000 at 3.88% interest per year. This installment promissory note is amortized and paid monthly over 12 years. The resulting trust's annual installment promissory note payments (of principal and interest fully amortized over 12 years) to the client equals $59,488 per year ($4,957 per month x 12 months). Since the trust receives $65,000 of income each year from the FLP limited partner interest, the trust would have enough money to pay the annual $59,488 interest and principal on the installment promissory note.**
>
> **In this example there are no income tax consequences on the sale of the FLP interest to the grantor trust. Effectively, the client's 75% limited partner interest's value is being "frozen" in the grantor trust. Assuming that the client lives the entire 12 years, the entire promissory note would then be paid to the client (with total payments of $713,856 of interest and principal to the client over the 12 years). At the end of 12 years, the trust owns a 75% FLP limited partner interest which represents $1,000,000 of underlying FLP real estate <u>plus any appreciation</u> in that FLP's real estate over that 12-year period.**

(h) ***<u>Alternative Ways to Structure the Promissory Note Which is Paid By the Defective Income Trust to the Grantor</u>***. There appears to be no prohibition on having the promissory note pay interest only for a period of time (even having an interest-only promissory note until a specified due date). However, the promissory note should reflect terms that a similar commercial lender would charge under similar circumstances.

(i) ***<u>Currently Selling the FLP Interests to a Defective Income Trust May Avoid Potential Future Tax Law Changes</u>***. A current transfer of real estate to a FLP, followed by the sale of the FLP interest to a defective income trust can take advantage of the current tax laws' allowance of FLP valuation discounts. In the future Congress may pass tax legislation (or the Treasury may promulgate Regulations) disallowing or restricting valuation discounts for FLPs and for sales among family members.

10. **PLANNING FOR INCOME TAX BASES' ADJUSTMENTS WHERE A PARTNERSHIP OWNS REAL ESTATE**

10.1 ***Income Tax Basis of Real Estate Owned Directly By the Decedent***. The income tax basis of real estate owned by a decedent at death is adjusted ("stepped up" or "stepped down") to its fair market value at the date of the decedent's death (or alternate valuation date if such date applies).[116]

10.2 ***Income Tax Basis of Gifted Real Estate***. Real estate which is gifted by parents to donee family members causes these donees to have the same income tax basis in the gifted real estate as that real estate's income tax basis would have been in the hands of the donor parent. An exception is that if such income tax basis is greater than the fair market value of the property at the time of the gift, then for purposes of determining income tax losses, the income tax basis is such property's fair market value (on the date of the gift). The income tax basis of the gifted property is increased (but not above that property's fair market value at the time of the gift) by the amount of gift tax paid with respect to such gift.

10.3 ***Income Tax Basis of Real Estate Which is Community Property***. If the real estate (or FLP partnership interest) is community property, both the deceased spouse's share of that real estate (or FLP interest) and the surviving spouse's share of that real estate (or FLP interest) receive a basis adjustment under §1014(b)(6).[117]

The §754 basis adjustment to the inside bases of the FLP's assets will apply to both the deceased spouse's and the surviving spouse's share of the FLP's community property partnership interest.[118] In other words, upon the death of either spouse the surviving spouse benefits by the §754 election for the entire community property FLP interest.

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[116] See §1014(a)(1).

[117] California conforms to this Federal rule under California Revenue and Taxation Code § 18035.6.

[118] See Rev. Rul. 79-124, 1979-1 CB 224.

10.4 ***Income Tax Basis of a Partner's "Outside" Partnership Income Tax Basis***. When a FLP partner dies, that deceased partner's outside FLP partnership interest's income tax basis is adjusted under §1014 to its date of death value (or alternate valuation date if such date applies).[119]

10.5 ***Section 754 Election For Partnership Interests***. If the deceased FLP partner's outside partnership interest's income tax basis is higher than that deceased partner's share of the FLP's real estate income tax basis, then a §754 election should be considered in order to adjust the deceased partner's share of its "inside bases" of the FLP's real estate and other assets under §743(b).[120] A §754 election (which then causes §743 to operate) provides for an adjustment in the deceased FLP partner's share of their inside income tax bases of the FLP's real estate and other assets, which is the difference between the deceased partner's outside FLP interest's tax basis and the deceased partner's share of the inside tax bases of the FLP's assets (such as real estate).

The result of the §754 election (with its §743 adjustment) is that pre-contribution gain or loss under §704(c) with respect to the deceased partner is eliminated.[121]

For example, if the FLP was holding appreciated depreciable real estate, a §754 election will probably be beneficial to the deceased partner's estate since it would step up the deceased partner's share of such FLP's real estate's tax basis, thereby increasing future depreciation and amortization

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[119] Any income in respect to a decedent (known as "IRD") which is attributable to the deceased partner's partnership interest reduces this fair market value amount under §1014(c). If the FLP interest is not discounted for valuation purposes, then the IRD items generally create no problems in the calculation of the FLP outside basis. However, where valuation discounts are applied to FLP interests, the reduction in the deceased partner's outside basis by the undiscounted amount of the IRD items could magnify a reduction in the adjustment downward in the FLP's owned real estate income tax bases (known as the "inside basis"). On the other hand, if the IRD items in the FLP's outside income tax basis were discounted, then this would avoid magnifying a reduction in the FLP's real estate tax bases.

[120] When a §754 election is made, the bases of the FLP's assets will be adjusted in the manner provided in §743, in the case of a transfer of FLP interests; and in the manner provided in §734, in the case of a distribution of FLP assets. Both §§734 and 743 adjust the distortion between a FLP's inside assets' tax bases and the FLP partner's outside partnership interest's tax basis.

The §754 election applies with respect to all transfers of FLP interests during the taxable year in which the election is made and all subsequent taxable years, unless the election is revoked as provided in Reg. §1.754-1(c).

[121] See Reg. §1.743-1(j).

deductions to the deceased FLP partner's estate, as well as reducing potential gain to the deceased partner's estate on any FLP sale of that real estate.

10.6 ***Effect of Valuation Discounts on the FLP's Real Estate Income Tax Bases Adjustment***. Even where discounts for lack of marketability and minority interests are utilized, if the deceased partner's outside partnership basis (valued with valuation discounts) is higher than that deceased partner's share of the underlying FLP's real estate, a §754 election will in most cases be advantageous to the deceased partner's estate.[122]

Because of lack of marketability and minority valuation discounts of FLP interests, the outside income tax basis of a deceased FLP partner may be lower than that deceased partner's proportionate share income tax basis of the FLP's real estate. Under these circumstances, a §754 election can lead to a "step-down" in the deceased partner's share of FLP's real estate's tax basis. Accordingly, if valuation discounts produce an outside deceased partner's partnership interest tax basis which is less than that deceased partner's share of the FLP's inside real estate's income tax basis, then no §754 election should be made. Note, however, in certain cases the mandatory income tax basis adjustments to the partnership's owned property as discussed at paragraph 10.7, below, may apply.

10.7 ***Required Mandatory Income Tax Basis Adjustments to a Partnership's Owned Real Property***. For transfers of FLP interests, including those transfers upon the death of a partner (see §743(a)), the FLP in some cases is required to adjust the income tax basis of the FLP's assets even if no §754 election is in effect.

(a) ***Substantial Built-in Loss of §743***. The §743 basis adjustment rules are mandatory if there is a transfer of the FLP interests (by sale or because of the death of a partner which causes a deemed transfer) for which there is a "substantial built-in loss" of the FLP's assets.

There is a "substantial built-in loss" if the FLP's income tax bases in the FLP-owned assets (such as real estate), in their totality, exceed by more than $250,000 the fair market value of those FLP's total assets.[123] In other words, the $250,000 threshold test is computed as to the entire FLP assets' tax bases over such total FLP assets' value. Thus, the §743(d) rules mandate that the deceased partner's share of the FLP's assets' tax bases will be reduced as if that FLP had made a

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[122] The calculation of the FLP's assets' tax bases from the adjustment to the deceased partner's valuation discounted outside basis is not totally clear under the §755 Regulations. Under Reg. §1.755-1(b)(3)(iii), example 2, there was an adjustment to the partner's outside partnership interest tax basis, which was less than that partner's pro rata share of the partnership's underlying assets' fair market value.

[123] See § 743(d)(1).

§754 election. This §743(d) rule mandates negative income tax basis adjustments (but not positive basis adjustments).

The determination of whether there is a "substantial built-in loss" calculation is based on all of the FLP's assets, and if there is a "substantial built-in loss" then the deceased FLP partner's share of the FLP's assets' (such as real estate) income tax bases is decreased (but only that deceased partner's share of FLP assets) by the excess of: (i) that deceased partner's share of the adjusted income tax bases of the FLP's assets; over (ii) that deceased FLP partner's income tax basis in its partnership interest.

> **Example: Assume that the FLP has real estate with a total fair market value of $4,000,000 and an income tax basis of $5,000,000. Assume that a FLP partner owning a 1% limited partner interest dies. Because the total FLP properties' income tax bases exceeds their total fair market value by more than $250,000 (in this example by $1,000,000), the $250,000 loss threshold is met. Thus, the deceased FLP partner's estate will be required to make a mandatory §743 downward income tax basis adjustment in its proportionate share of the FLP's real estate. The result is a $10,000 downward adjustment (1% limited partnership interest owned of the $1,000,000 of tax basis in excess of fair market value). However, if the deceased partner's outside basis is discounted by valuation discounts, then instead of being worth $40,000 (1% of $4,000,000), the 1% interest might, for example, be worth $24,000 after valuation discounts ($40,000 value less a 40% valuation discount), in which case the §743 adjustment would then be a $26,000 downward adjustment ($50,000 share of the real estate's inside income tax bases less the $24,000 discounted outside partnership interest basis value), rather than a $10,000 downward adjustment.**

As the above example illustrates, valuation discounts under the mandatory valuation adjustment rules of §743(b) may magnify and substantially increase the downward bases adjustments of a deceased FLP partner's share of the FLP's real estate.

(b) ***Substantial Basis Reduction of §734***. The inside bases adjustment of a FLP's real estate and other assets is also mandatory (rather than elective) under §734 if there is a distribution to partners of partnership property for which there is a "substantial basis reduction."[124] A substantial basis reduction means where a downward adjustment of more than $250,000 would be made to the tax bases of the FLP's assets if a §754 election were in effect.[125] Accordingly, a §734(b) adjustment to the FLP's inside assets' tax bases is required in the liquidation of a partner's

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[124] See §734(a).

[125] See §734(d)(1).

interest if the reduction in the tax bases of the FLP's real estate and other assets (assuming a §754 election were in effect) would exceed $250,000. This §734(b) provision will be triggered, for example, by a FLP liquidating distribution of appreciated real estate to a FLP partner with a high outside partnership interest tax basis.

If a partner dies (and even if the partnership fails to make a §754 election) these mandatory income tax basis adjustment rules can still trigger a reduction in the remaining FLP real estate's bases if real estate is distributed to the deceased partner's estate. This results from the fact that the deceased partner's FLP interests' outside tax basis gets stepped up at death, but without a §754 election the FLP real estate distributed to that deceased partner's estate has a lower tax basis, which in turn (as the above examples show) results under §734(b) in a decrease to the remaining FLP assets/real estate tax bases. The above assumes that there is a substantial basis reduction for the FLP property distributed to the deceased partner's estate. Therefore, in this fact scenario it is advantageous to the continuing partners (along with the deceased partner's estate) that the FLP make a §754 election on the partner's death in order to avoid this potential future FLP real estate tax bases reduction.

10.8 ***Required §754 Notice to the FLP By a Deceased Partner's Estate***. When a FLP partner dies, the transferee partner (for example the deceased partner's estate or revocable living trust) which receives the deceased partner's FLP interest having a §754 election in effect must notify the FLP of its acquisition of the deceased partner's FLP interest in writing, and such notice must be delivered to the FLP within one year of the death of the deceased partner.[126]

A practical issue with this notice to the FLP is how the fair market value of the deceased partners's FLP interest will be determined, since it may be several months after the decedent's date of death before the deceased FLP partner's estate's appraiser is able to prepare the FLP partnership interest appraisal (including any valuation discounts). If there is an IRS estate tax audit, or even litigation between the decedent's estate and the IRS, then the final determination of the value of the deceased FLP partner's interest could take several years. Upon the final determination of the federal estate tax fair market value (including any discounts) of the deceased partner's FLP interest, the inside tax bases of the FLP's real estate attributable to that deceased partner can then be determined if a §754 election has been made.[127]

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[126] See Rev. Proc. 2002-71 and Reg. §1.743-1(k)(2). The estate (or the decedent's revocable living trust) in the notice should provide the FLP with the deceased partner's name, address and tax identification number, along with that deceased partner's date of death and the fair market value of the FLP interest in the estate on the deceased FLP partner's date of death.

[127] The FLP and the deceased partner's estate can amend their income tax returns at the time of such final valuation determination for tax years falling within the three-year income tax statute of (continued...)

When a §754 election is in effect and the FLP has knowledge of the deceased partner's transfer, then the FLP is required to attach a statement to the FLP's income tax returns.[128] This FLP statement contains the deceased partner's name, taxpayer identification number, and the computation of the deceased partner's adjustment under §743(b).

11. AVOIDING A CHANGE OF OWNERSHIP OF THE REAL ESTATE UNDER THE CALIFORNIA PROPERTY TAX RULES

Many times clients wish to transfer to younger generations real estate that the client has owned for many years. Also, clients fund FLPs with real estate which has been owned by the client for many years. In such cases this real estate probably has a low property tax assessed value due to California's Proposition 13.[129] Clients generally do not want to lose the benefit of their real estate's low assessed property tax basis when their real properties are transferred to younger generations or to a FLP. In other words, clients do not want to have a "change of ownership" of their real estate which would result in a reassessment of that real property for California property tax purposes (whether the real estate is contributed to a partnership or otherwise).[130]

A change of ownership of real property includes:

(a) the transfer of a present interest in the real estate, such as by a gift or sale of that real estate;

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[127](...continued)
limitations.

[128] See Reg. §1.743-1(k)(1).

[129] See California Constitution Article 13A, and California Rev. and Tax. Code §§60 to 63.1. Proposition 13 enacted these changes in 1976 by amending the California Constitution. Proposition 13 made 1975-1976 real estate assessed value that real estate's initial baseline property tax year.

Proposition 13 limited property taxes to being 1% of the real property's assessed value, plus certain local taxes. Proposition 13 also limited annual real property value increases for property tax purposes to the lesser of: (i) the baseline value, adjusted by an inflation rate of 2% per year; or (ii) the actual cash fair market value of the real estate. Although 1976 was the first baseline year, generally the baseline year will be the year of the real estate's acquisition or change of ownership. Thus, if a "change of ownership" occurs, then this 2% limitation does not apply, and the real estate is assessed to its then fair market value. See California Rev. and Tax. Code §61.

[130] See California Rev. and Tax. Code §§60 and 61 for a list of items that constitute changes of ownership.

(b) the creation or termination of a tenancy-in-common in that real estate, unless the transfer is to or from the real property's owners in proportion to their ownership of the real property;

(c) transfers of real estate between a partnership or other legal entity and a partner or other person, unless that transfer is in direct proportion to the owners' interests in the real property;

(d) if a person obtains majority ownership interests in any partnership, limited liability company or other legal entity[131]; or

(e) if more than 50% of a partnership's or a limited liability company's original co-ownership percentages are transferred.[132]

When deeds are recorded with the County Recorder's office in California, a Preliminary Change of Ownership Report (sometimes referred to as a "PCOR") must accompany that deed at the time that deed is delivered to the County Recorder's office for recordation. The PCOR form contains a list of various exemptions to a change of ownership.

California statutes and property tax rules promulgated under Proposition 13 provide planning opportunities to structure the transfer of real properties to children, grandchildren and FLPs, and to avoid a change of ownership.

11.1 ***Same Proportionate Ownership Exception of §62***. The California statute provides that if real property is transferred to a partnership in which the former co-owners of that real property own partnership interests exactly equal to their prior co-ownership interests in that transferred real property, then the transfer does not constitute a change in ownership.[133] These former owners (who now own partnership interests) are then referred to as the "original co-owners."

Example: Assume parents own a 60% tenancy-in-common interest and their child owns a 40% tenancy-in-common interest in an apartment building. The parents and child contribute by deed their respective tenancy-in-common interests to a limited partnership, in which the child takes back a 1% interest as a general partner and a 39% interest as a limited partner, while the parents take back a 60% interest as limited partners. There is no change of ownership

[131] See California Rev. and Tax. Code §64(c).

[132] See California Rev. and Tax. Code §64(d).

[133] See California Rev. and Tax. Code §62(a)(2).

under §62(a) because the proportionate ownership of the parents and child in the apartment building (60%/40% as tenants-in-common) was the same as their percentage interests in the limited partnership after the transfer.

11.2 ***Change of Ownership Exception For Transfers Between Spouses or Registered Domestic Partners***. A transfer of real property between two spouses (and between registered domestic partners) is not a change of ownership.[134]

11.3 ***Change of Ownership Exception For Transfers Between Parents and Children***. An important exception to a change of ownership is that a transfer of property between a parent and a child is not a change of ownership to the extent the aggregate full cash value (for property tax purposes) of all property transferred under this exemption is $1,000,000 or less; or that the transferred property is the transferor's principal residence.[135] Thus, two spouses owning community property in the aggregate have a total exemption of $2,000,000 of cash value of real estate.

It should be noted that this parent-child exemption does not apply to the transfer of partnership, or FLP, interests between parents and their children, but only applies to the transfer of the fee interest in the real property between parents and their children. Therefore, when parents transfer real property to a FLP in which their children are to receive FLP interests, the parents should use a two-step process. First, the parents should transfer a portion of their real estate's fee interest to their children utilizing the parent-child property tax exemption. Second, the parents and their children should then transfer their respective fee interests in the real estate into the FLP utilizing the "original co-owner rule" of §62(a)(2).

(a) ***Trusts For Benefit of Children***. Transfers to children include transfers to an inter vivos or testamentary trust where that child has a present trust beneficial interest under §63.1(c)(9) of the California Revenue and Taxation Code. Thus, if the child holds a "present beneficial interest" in the trust, then it will be deemed as if the real property was transferred to that child.[136]

Example: Parent sets up a GRAT under which the parent receives all of the income from the GRAT for seven years, with the remainder interest vesting in

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[134] See California Rev. and Tax. Code §§63 and 62(d).

[135] See California Rev. and Tax. Code §63.1. The $1,000,000 exclusion applies for each eligible transferor/parent. A grandchild would qualify for this exception to receive a transfer of property from their grandparent if that grandchild's parent (which grandchild's parent is the child of the grandparent transferring the property) is then deceased.

[136] See California State Board of Equalization Annotation 220.0790.

the parent's child (or trust for the benefit of solely that child) at the end of the seven-year GRAT annuity term. There is no change of ownership during the seven years since the parent (who was the original owner of the real estate transferred into the GRAT) is the sole beneficial owner in the form of the trust annuity interest. After the seven years the real estate is either going outright to the child or in trust for the child's benefit, and the parent-child exemption applies under §63.1. If the remainder beneficiaries are multiple children, then the parent-child exemption can be applied to that entire GRAT remainder interest.

If the trust in the above example contains a sprinkling power by which the trustee can "sprinkle" the income and principal among not only children (who qualify for the parent-child exemption), but also to non-qualifying beneficiaries (such as a nephew), then that trust would not qualify for the parent-child exemption, and there would be change of ownership upon transfer of the real property to such a trust under Rule 462.160(b)(1)(A), example 2.

11.4 ***After Real Estate is Transferred to a FLP, Later Transfers of FLP Partnership Interests Can Trigger a Change of Ownership***. After a FLP is funded with real estate, later transfers of FLP interests (whether by a gift or a sale) can trigger a change of ownership of the FLP-owned real estate.[137]

(a) ***Transfer of More Than 50% of FLP Capital and Profits of the Original Co-owners Can Trigger a Change of Ownership***. If, upon the real estate partnership's formation, the partnership claimed the benefit of §62(a)(2) as the real estate's transfer being a change solely in the manner of holding title to the real property, then these original partners who created the FLP are defined as "original co-owners". If these "original co-owners" then subsequently transfer in the aggregate FLP partnership interests constituting more than 50% of the FLP capital and profits, a change in ownership of all of this previously contributed FLP real property will result.[138] Thus, a change in ownership of all of the previously contributed FLP real property will occur once the transfers of FLP interests cross this 50% threshold limitation.

Accordingly, if the parents form the FLP using the §62(a)(2) original co-owner rule, then the parents should not later transfer more than a 50% interest in their FLP capital and profits interests in order to avoid a change of ownership (and the resulting reassessment of the FLP's underlying real property).

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[137] Under California Rev. and Tax. Code §64(c), the California Franchise Tax Board now includes questions on the California Partnership Tax Return asking about changes in ownership of entities.

[138] See California Rev. and Tax. Code §64(d) and California Code Regs. 462.180.

The death of the parents (who are original co-owners) can result in a greater than 50% partnership interest transfer, thereby causing a change of ownership to the partnership's previously contributed real property.

(b) ***Transfer of Greater Than 50% Interest in FLP Capital and Profits Can Trigger a Change in Ownership***. Another property tax rule which can cause a change of ownership to occur is the so-called "control rule." Under the control rule, if any person acquires a greater than 50% interest in the partnerships capital and profits, then a change of ownership results and a reassessment of the partnership's property occurs.[139]

(c) ***The Property Tax Step-transaction Rule Does Not Apply to Parent Transfers to Children***. Under the California property tax rules, a "step-transaction doctrine" is applied when a series of transfers are made merely to avoid reappraisal of the real estate. In such case the "substance of the transaction rather than the form" will determine if a change in ownership has actually occurred.[140] However, in the case of applying the parent-child exemption, the legislative history states that the step transaction should not apply. Thus, the step-transaction doctrine is not to apply to transfers of real property and transfers of legal entity interests (such as FLP interests) between parents and their children.[141] The California State Board of Equalization has indicated that the parent-child exemption applied to the following transaction to avoid having a change of ownership:

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[139] See California Rev. and Tax. Code §64(c).

[140] See ***Shuwa Investment Corp. v. County of Los Angeles***, 1 Cal.App.4th, 1635 (1991).

[141] See California State Board of Equalization letter to taxpayer at annotation 625.0196 issued December 8, 2005, where the State Board of Equalization states in citing this legislative history of the step-transaction:

> "... it is the intent of the Legislature that the provisions of §63.1 of the Revenue and Taxation Code shall be liberally construed in order to carry out the intent of Proposition 58 on the November 4, 1986 general election ballot to exclude from change in ownership purchases or transfers between parents and their children described therein. Specifically, transfer of real property from a legal entity to an eligible transferor or transferors, where the latter is the beneficial owner or owners of the property, shall be fully recognized and shall not be ignored or given less than full recognition under substance-over-form or step-transaction doctrine, where the sole purpose of the transfer is to permit an immediate retransfer from an eligible transferor or transferors to an eligible transferee or transferees which qualifies for the exclusion from change in ownership provided by §63.1..."

Example:

Step 1: The husband and wife, as co-owners of the real property, transfer the real property to a FLP, with each spouse receiving a 50% partnership interest in the FLP. This transaction is exempt from a change of ownership because it is solely a change in the method of holding title under §62(a)(2). Husband and wife become "original co-owners" under §64(d).

Step 2: Husband and wife each gift one-half of their partnership interest (which is a 25% FLP partnership interest) to their son, so that husband and wife each now own a 25% interest and the son owns a 50% in the FLP. Since husband and wife are transferring only a 50% total amount of their partnership interests in the FLP, there is no change in ownership under §64(d) since there is not greater than a 50% transfer. Furthermore, since the son is only acquiring a 50% partnership interest, there is no change of ownership under §64(c) (since not more than 50% control is transferred). Thus, there is an exclusion of the transfer of the FLP partnership interests from being a change of ownership.

Step 3: The FLP liquidates and transfers the real property to the husband, wife and son in the liquidation in proportion to the husband's, wife's and son's respective partnership percentage interests in the FLP, and husband, wife and son hold such property as tenants in common. Since before and after the transfer the partners own the exact same percentage interests (husband owning 25%; wife owning 25%; and son owning 50%) both in the FLP and in the real property as tenants in common, there is no change in the proportionate ownership interests of the transferors and transferees. Thus, the §62(a)(2) exclusion from change of ownership applies. Furthermore, husband and wife are no longer "original co-owners" since they are no longer partners in the FLP (the FLP has now liquidated).

Step 4: Husband and wife transfer one-half of their respective tenancy-in-common interests to their son (12.5% by each parent to son), with the result that husband and wife now each own a 12.5% tenancy-in-common interest in the real property and the son owns a 75% tenancy-in-common interest in the real property. Here, since real property is being transferred to the son (a total of a 25% tenancy-in-common interest to son by parents), the §63.1 parent-child exclusion will apply (subject to the $1,000,000 cash value limitation set forth in §63.1(a)(2)).

Step 5: Husband, wife and son transfer the real property to a second FLP, with each of them receiving the same proportionate partnership interest in the new

FLP, namely husband and wife each own a 12.5% interest and son owns a 75% interest in the new FLP. In this example, since there is no change in the method of holding title in which the proportionate interests of the transferors and transferees are exactly the same after the transfer, the §62(a)(2) exclusion applies and there is no change of ownership. Husband, wife and son are now new "original co-owners" under §64(d) in this new FLP.

<u>Step 6</u>: Husband and wife transfer their remaining 12.5% partnership interest in the new FLP to their son, with the result that the son becomes the sole partner of the FLP (which FLP in turn owns the underlying real property). So that there is more than one partner, son uses his single-member LLC as a second partner for a small percentage of son's partnership interests. In this last step there is no change of ownership under §64(d) since the husband and wife are transferring <u>less</u> than a 50% interest. Furthermore, since the son owned <u>more</u> than a 50% partnership interest in the new FLP prior to the transfer, there is no change in control under §64(c). Thus, this step 6 is excluded from being a change of ownership.[142]

11.5 ***<u>Transfers of Real Property From a FLP</u>***. A FLP may want to transfer some or all of the FLP's real properties to the FLP's partners. For example, children after the death of their parents may wish to liquidate real properties from the FLP. Alternatively, during the life span of a FLP, the FLP may distribute real properties to only certain partners. These real property distributions from a FLP <u>can cause</u> a change of ownership to the distributed real property. To avoid such a change of ownership, all of the FLP partners must receive distribution of FLP real property in the exact same ownership percentages as such partners' FLP interests.[143]

<u>Example</u>: Assume that the FLP is owned by the parents' four children in equal percentages (25% each). The FLP consists of four real properties, each property having an equal value. The parents died over 10 years ago, and the children now wish to liquidate the FLP, with each child to receive one real property on the liquidation. If each child receives a 100% interest in one of the four real properties in liquidation of the FLP, <u>there will be a change of ownership</u> as to each real property distributed to the children, since each child owns a 100% interest in their own respective real property after the distribution (not a 25% interest in each of the four real properties). Thus, the proportionate ownership of each of the four properties changed under §62(a)(2) on the

[142] See California State Board of Equalization Annotation 625.0196.

[143] See California Rev. and Tax. Code §62(a)(2).

properties' distribution, resulting in a change of ownership for all four properties.

<u>An alternative tax plan</u> to avoid this change of ownership is instead for the four children to each receive a 25% tenancy-in-common interest in <u>each</u> real property upon liquidation of the FLP, and then have the children later do a §1031 tax-free exchange of their real property interests among themselves. Note, however, that there may be a "holding" issue for §1031 income tax purposes.

12. <u>HOW TO PAY THE ESTATE TAXES ATTRIBUTABLE TO REAL ESTATE</u>

When estate taxes become due on real property, alternatives must be found as to how to pay such taxes. Generally, the Federal estate taxes are due nine months after the date of the decedent's death. Real estate may be difficult to sell because of market conditions. Refinancing real estate may not be an alternative because the real estate is currently encumbered or loans against real estate may not then be readily available (such as the current real estate market conditions where it is difficult to finance real estate).

Sections 6166 and 6161 are two Internal Revenue Code provisions which can assist taxable estates composed of real estate to pay Federal estate taxes in installments, rather than paying the entire estate tax amount nine months after the date of the client's death.

Life insurance is another way to provide liquidity to estates owning substantial amounts of real estate. See the discussion at paragraph 13, below.

12.1 ***<u>Deferring the Payment of Estate Taxes Under §6166</u>***. Under §6166 an estate may defer the payment of Federal estate taxes to the extent that these taxes are attributable to a closely held trade or business.

<u>Example</u>: Assume that 70% of the adjust gross estate consists of real estate which qualifies as a closely held business under §6166. The result is that 70% of the Federal estate taxes may be deferred pursuant to the provisions of §6166.

Importantly for real estate, §6166 applies to partnerships, sole proprietorships and limited liability companies. Section 6166 permits an estate to pay only the interest due on the estate taxes for the first four years. Then beginning in year five, the estate must pay all accumulated interest and 10% of the deferred estate taxes each year.

(a) ***<u>Summary of §6166's Operation</u>***. Section 6166 provides for the payment of estate taxes in installments (basically, that fraction attributable to the inclusion in the decedent's gross estate of the business interest) over two to ten equal installments, and allows at least part of the interest on the unpaid balance to be paid at the rate of 2%, and for a reduced interest rate on the remaining estate tax due of 45% of the regular §6621 underpayment rate.[144]

(b) ***Requirements to Qualify Under §6166***. The decedent's interest in a "closely held business" must have an estate tax value which exceeds 35% of the decedent's adjusted gross estate.[145] Real estate may be a "closely held business," as described below. "Adjusted gross estate" means the decedent's gross estate value less the sum of amounts allowable as a §2053 or 2054 deduction.[146] Thus, to determine the adjusted gross estate, §2053 funeral expenses, administrative expenses, claims against the estate, unpaid mortgages, etc. are deducted. Gifts made by the decedent within three years of death of death are included in determining whether the 35% test is met, but such gifts are not included for purposes of determining the amount of tax that may be deferred under §6166.[147]

(c) ***Limitations on the Amount of Estate Taxes That Can Be Paid in Installments***. Under §6166 the amount of estate taxes that can be paid in installments is equal to an amount which bears the same ratio to the decedent's estate tax (reduced by the credit against such tax) as the decedent's estate's closely held business amount bears to the amount of the decedent's adjusted gross estate.[148]

(d) ***Number of Estate Tax Installment Payments Under §6166***. Section 6166 permits the payment of the qualified portion of the estate tax in up to ten installments. The first installment must be paid "on or before the date selected by the executor which is not more than five years after the date prescribed in §6151(a) for the payment of the tax."[149] In other words, the estate tax may be spread over a period of as long as 14 years from the date the tax is otherwise due.[150] The

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[144] See §6601(j). Note that the interest which represents these special §6166 interest rates are not deductible for estate or income tax purposes under §§2053(c)(1)(D) and 163(k).

[145] See §§6166(a)(1) and 6166(b)(6).

[146] §6166(b)(6).

[147] See §2035(d)(4).

[148] §6166(a)(2).

[149] See Reg. §20.6166-1(e)(2).

[150] Thus, it is not 15 years. The last installment payment is due on the beginning of the 15th year (continued...)

date on which each installment payment is due is the original due date for the payment of the estate tax without regard to any extensions. The first principal payment of estate taxes is due five years after such date, and subsequent annual estate tax installment payments are required on that same date in later years, of up to ten years.

(e) ***Interest Rates on Unpaid Estate Taxes Under §6166***. Section 6601(j) states that there is a 2% rate of interest payable on the deferred tax attributable to the first $1,520,000 (which $1,520,000 amount is for decedents dying in 2018, and this figure is adjusted in future years for inflation) in taxable value of a closely held business. Thus, for decedents dying in 2018, the tax attributable to the first $1,520,000 in value of the "closely held business" in excess of the unified credit exemption is subject to an interest rate of 2%. A favorable interest rate also applies to the remaining amount of the estate tax qualifying for §6166 treatment that exceeds this $1,520,000 amount. Interest on the deferred tax which exceeds the 2% portion is payable at a rate equal to 45% of the annual underpayment rate established under §6621.[151]

(f) ***When Real Estate Qualifies as a Closely Held Business For Purposes of §6166***. Section 6166 only applies to interests in a "closely held business," which can mean partnership interests, limited liability company membership interests, stock in a corporation, or even a proprietorship. For a partnership (or limited liability company) 20% or more of the capital interests in such partnership must be included in determining the gross estate of the decedent or such partnership must have 45 or fewer partners.[152]

Section 6166 only applies to a "business." Section 6166 is not intended to apply to "passive assets" held by an entity, such as rental real estate where the landlord has no duties or services. Often real estate operations and activities are performed by independent contractors, such as property management companies. Thus, where property management companies are utilized to perform most of the activities associated with real estate, those facts suggest that an active trade or business may not exist.[153]

The IRS in determining whether real estate is an active trade or business will look at all the facts and circumstances, including activities by employees and management companies. In Rev.

[150](...continued)
after the initial tax due date. During the first five years only interest needs to be paid.

[151] This means, for example, that if the underpayment rate is 4%, the effective interest rate is 1.8% (which is less than the 6601(j) 2% rate).

[152] §6166(b)(1)(B).

[153] See Rev. Rul. 2006-34.

Rul. 2006-34 the IRS announced it will consider the following items to determine if the real estate was a closely held business:

(i) the amount of time that the decedent (or the decedent's employees) devoted to the trade or business;

(ii) whether a physical outside office was maintained from which the real estate activities were conducted and whether the decedent (or the decedent's employees) maintained regular business hours for that purpose;

(iii) the extent to which the decedent (or the decedent's employees) were actively involved in finding new tenants and negotiating and executing new leases;

(iv) the extent to which the decedent (or the decedent's employees) provided landscaping, grounds care, or other services beyond the mere furnishing of the leased premises;

(v) the extent to which the decedent (or the decedent's employees) personally made, arranged for, performed, or supervised repairs and maintenance of the real properties (whether or not these repairs were performed by independent contractors), including without limitation painting, carpentry and plumbing; and

(vi) the extent to which the decedent (or the decedent's employees) handled tenant repair requests and complaints.[154]

The decedent's activities can be conducted through a partnership or a limited liability company. Having a separate legal entity strengthens the taxpayer's argument that a real estate business operation in fact exists. Under Rev. Rul. 2006-34 no single factor (as outlined above) will be dispositive as to whether the activities in respect to the real estate constitute an interest in a closely held business.

The IRS in Rev. Rul. 2006-34 provides five examples of whether real property is an active trade or business. These examples show a trade or business occurring where a decedent actively managed a retail shopping mall, including doing repairs. However, where the owner of an office park utilized an outside management company to lease, manage, provide repairs and maintain the office park no trade or business was found. Interestingly, where the management company that is providing all of the management, repair and leasing services is owned 20% or more by the decedent, then the decedent's ownership of such management company will make the decedent's real estate an active trade or business.

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[154] See Rev. Rul. 2006-34.

Where the decedent owned a 1% general partner interest and a 20% limited partner interest in a real estate partnership, the decedent's management of the partnership as a general partner qualified the partnership interests (limited and general) as a closely held business under Rev. Rul. 2006-34. In another example, where the decedent owned an active automobile dealership and the decedent then leased to his own dealership the real estate (which the decedent owned), the underlying real estate qualified as a trade or business since the automobile dealership was providing management duties for this real estate.

Where multiple real properties are owned by the decedent, some of these real properties may qualify as a trade or business while other real properties are deemed to be passive investments (thereby not qualifying as a trade or business under §6166).[155]

(g) ***How to Make a §6166 Election***. The election under §6166 is made no later than the last date for filing the Federal estate tax return or on the last date of the extension of time for filing granted of such return.[156]

> **Planning Idea: When the real estate may arguably constitute a closely held business and the estate is subject to death taxes, consider making a protective §6166 election by filing a written election with the estate tax return.**

(h) ***Acceleration of the Estate Tax Payments Due Under §6166***. If the closely held business is later disposed of, the deferred taxes are accelerated and become due. Upon such business's disposal, the extension of time for the payment of estate taxes ceases, and the balance of the tax which was previously payable in installments become due upon IRS notice. The events which can trigger this acceleration are: (i) the distribution, sale, exchange or other disposition of the real estate constituting the qualified closely held business; and (ii) the withdrawal from the underlying real estate trade or business of "money and other property attributable to" the closely held business interests or the aggregate of such disposition or withdrawals equals or exceeds 50% of the value of the closely held business interests.[157]

Therefore, if a §6166 election is in effect, clients must proceed cautiously in reorganizing or selling their real estate. Can some real estate within the real estate business be sold without triggering a §6166 acceleration of estate tax payment?

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[155] See PLR 200845023.

[156] See §6166(d) and Reg. §20.6166-1(a).

[157] See §6166(g)(1)(A).

12.2 ***Deferring the Payment of Estate Taxes Under the Alternative Provision of §6161***. For real estate not qualifying under §6166, §6161 may allow the deferral of payment of estate taxes. Section 6161(a)(2) allows the IRS to grant an extension of time to pay estate taxes for up to ten years upon the showing of "reasonable cause."[158]

(a) ***When Will "Reasonable Cause" Exist?*** The Regulations explain that the IRS will utilize the following factors to determine whether "reasonable cause" exists[159]: (i) the executor's inability to marshal assets to pay the estate taxes; (ii) the estate's assets consist largely of the right to receive payments in the future (such as royalties or accounts receivable); (iii) the substantial assets of the estate cannot be collected without litigation; and (iv) the estate does not have sufficient funds available after the making of reasonable efforts to convert assets (other than an interest in a closely held business) into cash, with which to pay the tax in a timely fashion. Real estate, because of its illiquid nature, would arguably qualify under clause (iv) of this paragraph, since arguably it is difficult to obtain a real estate loan and/or it is difficult to sell the real property.

(b) ***How to Apply For the Deferral of Estate Taxes Under §6161***. The application containing a request for an extension of time for paying the estate tax must: (i) be in writing; (ii) state the period for which the extension is requested; (iii) include a declaration under penalty of perjury; (iv) state the "reasonable cause" for which the extension to pay is being requested; and (v) be filed with the IRS on or before the date prescribed for the payment of the estate tax.

(c) ***Other Requirements of §6161***. The estate may be required to furnish a bond or other security on a §6161 election.[160] Interest will be charged at the current rate of interest under §6621 (which will be more than the interest rate under §6166). However, the interest under §6161 is a deductible administrative expense under §2053 for estate tax purposes.

13. USE OF LIFE INSURANCE TO PAY ESTATE TAXES IN CONNECTION WITH REAL ESTATE

Owners of large amounts of real estate can have liquidity problems upon their deaths, and thus their estates may lack the necessary cash to pay the estate taxes due (which are due nine months after date of death). Many times additional monies cannot be borrowed against the estate's real estate because of a weak lending environment (such as in the current economy), the real estate is already fully leveraged, or existing loan restrictions prohibit the refinancing of the real estate.

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[158] §6161(a)(2).

[159] See Reg. §20.6161-1(a)(1) and the examples thereunder.

[160] See Reg. §§6161(d) and 20.6165-1(a).

Selling the real estate at the client's death may be difficult due to the then economic conditions. Finally, a sale of real estate at death may bring in lower prices as a "fire sale." All of these scenarios can leave the decedent's heirs with limited choices. The client might consider an orderly sale of the real estate during the client's lifetime, but in such a case significant capital gain taxes may have to be paid (because that sold real estate has not yet received a step up in income tax basis upon the client's death).

The client could try to rely on the installment payment of estate taxes under §§6166 or 6161, discussed at paragraph 12, above.

Another solution for paying estate taxes for estates owning illiquid real estate is to obtain life insurance on the client's life.

13.1 ***Issues in Obtaining Life Insurance***. A client concern in obtaining life insurance is the insurance premium cost, especially for older clients. Many times the issue of obtaining life insurance to pay estate taxes is only focused on when the client is elderly (such as over age 60), at which age life insurance premiums can be substantial. One technique to reduce the amount of insurance premiums is to purchase an insurance policy insuring both spouses (sometimes referred to as a "survivorship policy"). In this way the actuarial lives of both spouses are utilized to price the insurance premium. If an estate is properly planned, there will be no estate taxes due until after the deaths of both spouses, at which time the survivorship policy will pay the insurance death benefits.

13.2 ***Tax Issues in Planning the Purchase of Life Insurance***. If life insurance is purchased to fund all or a portion of the Federal estate taxes due upon the client's death, then a tax goal will be for the life insurance proceeds not to be included in the client's taxable estate. Life insurance proceeds are includable in an insured's gross estate under §2042 if, at the time of the insured's death, the insured owned the policy or possessed any "incidents of ownership" in that life insurance policy.[161] References to "incidents of ownership" includes the right of the insured or the insured's estate to the economic benefits of the life insurance policy; the right of the insured to change the beneficiaries of the policy; the right of the insured to surrender, cancel, assign or pledge the policy; or the insured's right to borrow against the policy.[162]

To avoid the insured from owning any of the insurance policy's incidents of ownership at death, one planning technique is to have the insurance policy owned by an irrevocable life insurance trust.

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[161] See §2042(2).

[162] See Reg. §20.2042-1(c)(1).

13.3 ***Life Insurance Trusts***. An irrevocable life insurance trust could be established for the benefit of the decedent's children. A survivorship policy (insuring the life of both the spouses) could also be owned by an irrevocable trust and the insurance policy proceeds paid to the trust upon the decedent's death. Each year the spouses could gift money to the life insurance trust in order for the trust to be able to pay the annual insurance premiums. So-called "***Crummey*** powers" in the trust document can generate enough annual gift tax exclusions to prevent a gift tax on the cash gifts used to pay the life insurance premiums.

When the insured dies the insurance trust will collect the life insurance proceeds and can then utilize these proceeds to purchase the real estate from the decedent's estate. In this way, the estate receives cash (to pay the estate taxes), and the irrevocable life insurance trust receives the real estate. Because of the step up in the income tax basis of the real estate at death, no capital gain tax would be incurred upon the sale of that real estate to the life insurance trust. The children, who are the life insurance trust beneficiaries, will then receive the benefits of this real estate under the terms of the trust.

13.4 ***Having the Partnership Own the Life Insurance Policy***. Another tax planning technique is for the real estate partnership to own the life insurance policy. It is important that the insured not be the general partner of the partnership to avoid the insured from having "incidents of ownership." The partnership could utilize the rental income from the partnership's real estate to make the annual life insurance policy premium payments. Upon the insured's death, the partnership would receive the life insurance policy proceeds, thereby increasing the partnership's value. See PLR 9843024 where the IRS found that the insured did not possess any incidents of ownership as a limited partner in a limited partnership.

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