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HOW TO ACQUIRE REAL ESTATE

and

HOW TO EXIT REAL ESTATE

BY

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CALIFORNIA CPA EDUCATION FOUNDATION

REAL ESTATE CONFERENCE

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Clients that acquire commercial real estate often ask "how should they take title" and "what is the best way" to own that real estate? There are tax and non-tax considerations when deciding on how to acquire real estate, as discussed in paragraphs 1 and 2, below.

When clients want to exit, cash out, or dispose of their real estate then clients can utilize the alternative tax planning strategies which are discussed at paragraph 4, below.

Clients generally will desire to avoid having a change of ownership for California property tax purposes when they transfer their real estate. Clients can consider the property tax planning strategies discussed at paragraph 3, below.

1. HOW SHOULD REAL ESTATE BE ACQUIRED?

Clients may acquire real estate as follows:

- **Community Property**. In community property states (such as

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California) real estate (or the interests in legal entities that own the real estate) can be titled in the husband's and wife's names as community property.

- **Title Real Estate as Joint Tenancy**. A joint tenancy will provide that the property automatically goes to the surviving joint tenant upon the death of the first joint tenant. For this reason, joint tenancies are generally utilized only among family members. Although this is a convenient way to avoid probate, the IRS could assert that in fact joint tenancy titled real estate is not community property and on the first spouse’s death deny a step-up in income tax basis for the surviving spouse's share of the real estate.

- **Title Real Estate as Tenancy-in-Common**. Many times clients will own real estate as tenants-in-common with other persons. A tenants-in-common relationship among spouses prevents 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. Tenancy-in-common relationships among non-related persons are many times utilized in lieu of partnerships. The main disadvantage of a tenancy-in-common relationship is that there is no limited liability to the owners. Also, if a disagreement should arise among the tenants-in-common, then each co-tenant has the right to file a partition action in the courts to force a sale of the real property.

- **Title the Real Estate in the Name of a Legal Entity Such as a Partnership or Limited Liability Company**. Most sophisticated clients will title their real estate in the name of a legal entity, such as a limited liability company or limited partnership. See the discussion of the types of legal entities, below.

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1.1. *__Goal in Choosing the Type of Legal Entity to Own the Real Estate is to Protect the Client Against Liabilities Generated by That Real Estate__.* Today, because of concerns over liability protection, clients will have real estate (other than their personal residence) owned in the name of a legal entity, such as a limited partnership or a 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 that sold real property's liability insurance policy and, thus, that client no longer has liability insurance coverage for future claims. Also, certain risks such as hazardous materials claims are not normally covered under standard liability insurance policies.

It is advisable for clients who own many parcels 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.

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1.2. *What Form of Legal Entity Should Own the Real Estate?* A C corporation should be avoided as an owner of real estate since there will be a 35 percent maximum Federal income tax, plus a California corporate income tax at 8.84 percent.

An S corporation doing business in California, although not having a Federal-level income tax on its earnings, will still be subject to the 1-1/2 percent corporate level California tax on its earnings.

Additionally, S corporation 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 could cause unexpected capital gains tax to the shareholders upon the S corporation's refinancing of its real estate and the distribution of those real estate refinancing proceeds to the shareholders, or from other debt financed distributions from the corporation to its shareholders.

Accordingly, for clients desiring liability protection, either a limited liability company or a limited partnership is preferable to own the real estate. A general partnership provides no liability protection to any of its partners.

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 only produces liability protection for its limited partners. Thus, in order to protect the general partner of a limited partnership from liability, the limited partnership's general partner should be either a corporation or a limited liability company.

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

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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 (see footnote 6, below, for amount of this fee). California limited partnerships are not subject to this gross receipts fee. [2]

1.3. ***Use a Revocable Living Trusts to Own the Interests in the Legal Entities That Own the Real Estate.*** In order to avoid probate, clients may choose to transfer their assets into a revocable living trust. Clients can transfer title to their real estate entities directly into a revocable living trust. For liability protection purposes clients should 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 interest in the legal entity (that owns the real property) go through the probate process (with its time consumption and costs), but also can serve to protect the privacy of the client.

1.4. ***No Prop 13 Reassessment of Real Estate Transferred to a Revocable Living Trust For California Property Tax Purposes***. Transfers of real estate entity interests to a revocable living trust (or from a revocable living trust back to the trustor) are excluded from being a change of ownership under Section 62 of the California Revenue and Taxation Code.[3] Additionally, upon the death of the first-to-die spouse, when the real estate entity interest is allocated to an irrevocable trust (such as a QTIP trust or a Bypass

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

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

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trust) where the surviving spouse is the sole income beneficiary, the transfer of real estate (or an interest in an entity that owns real estate) to such trusts is exempt from being a change of ownership for property tax purposes.[4]

1.5. ***Required Consents and Notifications of Lenders and Other Persons When Real Estate is Transferred to a Legal Entity***.

(a) **Insurance Policies**. When real estate is transferred into a new legal entity, the property insurance company insuring that real estate should be notified and the new legal entity designated as a loss payee on the insurance policy. Additionally, the new legal entity should be named as an additional insured on any liability insurance policy for that real estate.

(b) **Lenders**. If the real estate, which is transferred to a new legal entity, 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 a new legal entity are normally covered by deed of trust "loan acceleration" language unless a specific exception is included in the deed of trust document. Accordingly, clients may have to obtain the lender's consent when transferring real estate into a new legal entity. 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 is transferred to a new legal entity, then that property's tenants should be notified to make their rental payments directly to the new legal entity, and the leases should be assigned by a written

[4] See §63(h) of the California Rev. and Tax. Code and California Code Regs. §460.060(a).

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assignment to the new legal entity.

1.6. *Plan the Transfer of Real Estate to Avoid Other State's Estate and Inheritance Taxation of Real Estate Located in Those Other States*. California currently has no inheritance or pick-up estate tax.[5] However, if a decedent owns real estate in another state (whether owned outright or 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. Thus, California residents who own real estate in other states may have that real estate 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 that state's estate tax (or state 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 these 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 or inheritance 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 out-of-state

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

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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). These limited partnership or limited liability company interests would then have a tax situs in California where that California resident lived, and not in such other state.

2. ADVANTAGES AND DISADVANTAGES OF EACH TYPE OF LEGAL ENTITY TO ACQUIRE REAL ESTATE.

2.1. *C Corporation (A C corporation should generally not own real estate).*

Advantages of C corporations:

- Limited liability protection.
- No restrictions on types of owners of the stock.
- Relatively inexpensive and simple to form.

Disadvantages of C corporations:

- A C corporation incurs two levels of taxation, one at the corporate level and the second tax at the shareholder level when distributions are made to the shareholders or when the C corporation is liquidated. There is currently a 35% corporate level Federal tax plus an 8.84% California corporate

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level tax.

- Potential double level of tax when real estate is sold or assets are withdrawn from a C corporation. The maximum tax rate at the shareholder level would be at the individual tax rate which is 15% for qualified dividends (currently), but becomes a 39.6% ordinary income tax rate after December 31, 2012, plus the 3.8% shareholder level health insurance tax after December 31, 2012.

- Inability to increase the tax basis of the corporation's owned real estate upon the death of the shareholder.

- Imposition of employment taxes on corporate earnings paid as compensation or wages to a shareholder.

2.2. ***S Corporation (S corporations should generally not be used to own real estate).***

Advantages of S corporations:

- Limited liability protection.

- Relatively inexpensive and simple to form.

- Single level of income tax (but there are exceptions).

- No employment taxes on dividend distributions to family

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members.

Disadvantages of S corporations:

- Recalcitrant shareholder could attempt to terminate S election by transferring a share of stock to a nonqualified shareholder. For example, one disgruntled shareholder could terminate the S corporation election by transferring one share of their stock to a partnership. Need signed shareholders' agreement to prevent one shareholder from being able to terminate the S election.

- Potential §1374 built-in gains tax on appreciated real estate.

- Even though an S corporation is subject to only one level of federal taxation, that taxable income is realized at the corporate level and then this income passes through to the shareholders and a tax is then imposed on this income at the shareholders' level. This shareholder level tax is imposed on the shareholders whether or not the S corporation's earnings are distributed under §§1366 and 1368. The S corporation's distribution of appreciated real estate to its shareholders will cause that S corporation to recognize that distributed real estate's appreciation as gain at the S corporation level and then that recognized gain passes through to the shareholders. This gain is then allocated proportionately among the shareholders and increases the shareholders' stock bases. When the real estate is distributed to the shareholders, because the fair market value of the property will generally be

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less than the shareholder's stock bases (as increased by the real estate's recognized gain on the deemed sale of that real estate when that real estate is distributed from the S corporation to the shareholders), the shareholders will not have tax on the real estate's recognized gain a second time. [See §311(b)(1) and §1366.]

- There are restrictions on what type of shareholders can own stock in an S corporation and the types of stock which can be issued. For example, partnerships and LLCs may not be S corporation shareholders. Also, the number of S corporation shareholders is limited to 100 shareholders.

- If the real estate is sold by an S corporation, there is a potential double level of taxation under §1374 for built-in-gain.

- Inability to increase S corporation shareholders' stock and debt basis for corporate level debt. This could result in a lack of sufficient stock income tax basis for shareholders to use real estate tax losses, or result in potential shareholder gain on distribution of corporate loan proceeds (and real estate refinancing proceeds) to the shareholders.

- Inability to increase the tax basis of the S corporation's owned real estate upon the death of a shareholder. There is no §754 election for an S corporation.

- In California there is a corporate level tax on S corporation net income of 1.5%.

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- The one class of stock requirement for S corporations discourages the use of an S corporation to own real estate. Unlike a partnership or an LLC, an S corporation is not permitted to make special allocations of distributions or to make preferential distributions to its shareholders. An S corporation is treated as having one class of stock only if all outstanding shares of stock have identical rights to distributions and liquidation proceeds under Reg. §1.1361-1(l). This is an issue with real estate where it may be desired that certain investor groups receive a preferential distribution.

2.3. ***Limited Partnership.***

Advantages of limited partnerships:

- Limited partners have liability protection (even though the limited partnership's general partner does not have liability protection). If the general partner desires liability protection against the liabilities of their partnership then the general partner has to form a corporate general partner, or an LLC general partner (such as a single member LLC).

- One level of taxation on partnership earnings, which are passed through to the partners and taxed at the partner level.

- If a limited partnership's real estate is sold, then there is only one level of taxation on that real estate's recognized gain,

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which is at the partner level.

- No taxation on the partnership's distribution of appreciated real estate to its partners.

- Increased tax basis of partnership's real estate upon the death of a partner (or their spouse for partnership interests which are community property) if a §754 election is made by the partnership.

- Generally increased partnership interest "outside" basis for partnership level debt, allowing pass through to partners of increased tax losses from the real estate.

- No employment taxes apply to limited partners' share of income under §1402(a)(13). Note that the §1402(a)(13) exclusion does not apply to guaranteed payments to the limited partner for services rendered by that limited partner to the partnership.

- Permitted to have preferential distributions from the partnership to only certain partners.

Disadvantages of limited partnerships:

- General partner has no protection against the partnership's liabilities. To provide liability protection to the general partner, the client may have the expense of setting up another legal entity such as a corporation or a limited liability company to

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become the general partner.

- May be employment taxes upon the general partner's allocation of earnings (even if also a limited partner).

- May be more expensive to form due to greater flexibility in designing the limited partnership agreement. The flexibility of being able to structure the limited partnership agreement increases the costs of establishing the entity and the costs of drafting documents.

2.4. ***Limited Liability Company ("LLC").***

Advantages of limited liability companies:

- Members (including managing members) have liability protection.

- One level of taxation on earnings at the member level (except for the fee on the LLC's gross income as described below).

- If real estate sold by the LLC then there is only one level of taxation.

- One level of taxation on distribution of appreciated real estate by the limited liability company to its members.

- Increased tax bases of the LLC's real estate upon the death of

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an LLC member (or their spouse for community property) if a §754 election is in effect.

- Increased LLC members' interest "outside" tax basis for LLC level debt, which allows the pass through to the LLC's members of increased tax losses.

- LLCs are permitted to have preferential distributions to only certain LLC members.

Disadvantages of limited liability companies:

- May be employment taxes on the LLC's managing member's distributions.

- May be more expensive to form an LLC due to the greater flexibility in designing the LLC operating agreement. The flexibility of being able to structure the LLC operating agreement increases the costs of establishing the LLC entity and the costs of drafting documents.

- California imposes a fee on the LLC's total annual gross income as follows (which is in addition to the minimum annual $800 California franchise tax). Currently the fee is:

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California Fee[6]	Total Income
$900	$250,000 or more, but less than $500,000
$2,500	$500,000 or more, but less than $1,000,000
$6,000	$1,000,000 or more, but less than $5,000,000
$11,790	$5,000,000 or more[7]

3. AVOIDING A CHANGE OF OWNERSHIP UNDER THE CALIFORNIA PROPERTY TAX RULES WHEN TRANSFERRING REAL ESTATE.

Many times clients wish to transfer real estate that the client has owned for many years. Also, clients will fund legal entities 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.[8] Clients

[6] California Rev. and Tax. Code §17942.

[7] This California fee is imposed on the LLC's gross revenues (regardless of the amount of expenses or deductions). Thus, an unprofitable LLC may still have this fee imposed against it.

[8] 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 the 1975-1976 real estate assessed value that real estate's initial baseline property tax year for that real estate's property tax value.

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.

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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 a new legal entity or to another person. 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 that real estate is contributed to an LLC, partnership or otherwise).[9]

A change of ownership of real property includes:

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

(ii) 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;

(iii) 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;

(iv) if a person obtains majority ownership interests in any partnership, limited liability company or other legal entity;[10] or

(v) if more than 50 percent of a partnership's or a limited liability

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

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

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company's original co-ownership percentages are transferred.[11]

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 that could apply to that transfer of real estate.

California statutes and property tax rules promulgated under Proposition 13 provide planning opportunities to structure the transfer of real properties to partnerships, LLCs and corporations and to avoid there being a change of ownership.

3.1. ***"Same Proportionate Ownership" Exception to a "Change of Ownership," Under Section 62.*** The California statute provides that if real property is transferred to a partnership (or to a LLC) 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.[12] These former owners (who now own partnership interests) are then referred to as the "original co-owners."

> **Example: Assume two individuals own a 60 percent tenancy-in-common interest and a 40 percent tenancy-in-common interest in an apartment building. The two individuals**

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

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

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contribute by deed their respective tenancy-in-common interests to a limited partnership, in which one individual takes back a one percent interest as a general partner and a 39 percent interest as a limited partner, while the other individual takes back a 60 percent interest as a limited partner. There is no change of ownership under Section 62(a) because the proportionate ownership of the individuals in the apartment building (60%/40% as tenants-in-common) was the same as their percentage interests in the limited partnership after the transfer of the apartment building to the partnership.

3.2. ***Change of Ownership Exception For Transfers Between Spouses or Registered Domestic Partners.*** A transfer of real property between husband and wife or between domestic partners is not a change of ownership.[13]

3.3. ***Change of Ownership Exception For Transfers Between Parents and Children.*** An important exception to a change of ownership is that a transfer of real estate 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.[14] Thus, two spouses owning community property in the aggregate have a total exemption of

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

[14] 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.

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$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 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 partnership in which their children are to receive partnership interests, the parents should use a two-step process if the parents want to qualify for the parent-child exemption. 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 interests in the real estate into the partnership utilizing the "original co-owner rule" of Section 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 (such as being the sole trust beneficiary), then it will be deemed as if the real property was transferred to that child, and the transfer may qualify for the parent-child or other exemption.[15]

> **Example: Parent establishes a GRAT under which the parent receives all of the income from the GRAT for seven years, with the remainder interest vesting in trust for the benefit of the child at the end of the seven-year GRAT annuity term. There is no property tax change of ownership during the seven years**

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

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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 going 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 held in trust for the children.

If the child's trust 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 entire trust would not qualify for the parent-child exemption, and there would be change of ownership upon the transfer of the real property to that trust.

3.4. ***After Real Estate is Transferred to a Partnership, the Later Transfers of Partnership Interests Can Trigger a Change of Ownership.*** After a partnership is funded with real estate, the later transfers of partnership interests (whether by a gift or a sale) can trigger a change of ownership of the partnership-owned real estate.[16]

(a) **The Transfer of More Than 50 Percent of Partnership**

[16] Under California Rev. and Tax. Code §64(c), the California Franchise Tax Board now includes two questions on the California Partnership Tax Return asking about changes in ownership of entities. The California Franchise Tax Board then communicates the information from these questions to the California State Board of Equalization, which in turn then sends a Form 100-B "Statement of Change in Control and Ownership of Legal Entities" to the partnership.

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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 to the partnership being a change solely in the manner of holding title to the real property, then the original partners who created that partnership are defined as "original co-owners." If these "original co-owners" then subsequently transfer in the aggregate partnership interests constituting more than 50 percent of the partnership capital and profits, a change in ownership of all of this previously contributed partnership real property will result.[17] Thus, a change in ownership of all of the previously contributed partnership real property will occur once the transfers of partnership interests cross this 50 percent threshold limitation.

Accordingly, if client forms the partnership using the §62(a)(2) original co-owner rule exemption, then the contributing partners should not later transfer more than a 50 percent interest in their partnership capital and profits interests (of the original co-owners) in order to avoid a change of ownership (and the resulting reassessment of the partnership's underlying real property). Even the death of a partner (who is an original co-owner) is deemed a transfer and may result in a greater than 50 percent partnership interest transfer, thereby causing a change of ownership to the partnership's previously contributed real property.

(b) **The Acquiring of Ownership of Greater Than 50 Percent Interest in Partnership 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 one person acquires a greater than 50 percent interest in the partnership's capital and profits, then a change of ownership results and a reassessment of the

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

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partnership's property occurs.[18]

(c) **Property Tax Step-transaction Rule**. 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.[19]

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 does not apply to transfers of real property and transfers of legal entity interests (such as partnership interests) between parents and their children.[20]

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

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

[20] 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 Section 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 Section 63.1..."

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The California State Board of Equalization has indicated that the parent-child exemption applied to the following transaction:

Example of How to Transfer Real Estate and to Avoid a Change of Ownership Among Family Members:

The following transfer of real estate from parents to the son can be done gift tax free through gifts and sales to grantor trusts.

Step 1: The husband and wife, as co-owners of the real property with a property tax assessed value of $5,000,000 and a fair market value of $65,000,000, transfer the real property to a partnership, with each spouse receiving a 50 percent partnership interest in the partnership. 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 percent partnership interest from each of husband wife) to their son, so that husband and wife each now own a 25 percent interest and the son owns a 50 percent interest in the partnership. Since husband and wife are transferring only a 50 percent total amount of their partnership interests in the partnership, there is no change in ownership under §64(d) since there is not greater than a 50 percent

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transfer. Furthermore, since the son is only acquiring a 50 percent partnership interest, there is no change of ownership under §64(c) (since not more than 50 percent control is transferred). Thus, there is an exclusion of this transfer of partnership interests from being a change of ownership.

<u>Step 3</u>: The partnership liquidates and transfers the real property to the husband, wife and son in proportion to the husband's, wife's and son's respective partnership interests in the partnership, 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 percent; wife owning 25 percent; and son owning 50 percent) both in the partnership and after the liquidation 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 <u>no longer</u> "original co-owners" since they are no longer partners in the partnership (the partnership has now liquidated).

<u>Step 4</u>: Husband and wife transfer one-half of their respective tenancy-in-common interests to their son (12.5 percent by each parent to son), or $625,000 of assessed value by husband and $625,000 of assessed value by wife (12.5 percent interest by each parent x $5,000,000 property tax assessed value). The result is that husband and wife now each own a 12.5 percent tenancy-in-common interest in the real

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property and the son owns a 75 percent tenancy-in-common interest in the real property. Here, since real property is being transferred to the son (a total of a 25 percent tenancy-in-common interest transferred to the son by both parents), the §63.1 parent-child exclusion will apply, allowing each parent to transfer 12.5 percent (or $625,000) of assessed value to the son under this parent-child exclusion (which parent-child exclusion is subject to the $1,000,000 cash value limitation for <u>each</u> parent set forth in §63.1(a)(2)).

<u>Step 5</u>: Husband, wife and son transfer their respective tenancy-in-common interests in the real property to a second partnership, with each of them receiving the same proportionate partnership interest, which each parent owns, in the new partnership, namely husband and wife each own a 12.5 percent interest and son owns a 75 percent interest in the new partnership. 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 Section 64(d) in this new partnership.

<u>Step 6</u>: Husband and wife transfer their remaining 12.5 percent partnership interest which each parent owns in the new partnership to their son, with the result that the son becomes the sole partner of the partnership (which partnership in turn owns the underlying real property worth $65,000,000). So that

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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 less than a 50 percent interest. Furthermore, since the son owned more than a 50 percent partnership interest in the new partnership 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.[21]

This six (6) step process has allowed, in this above example, the parents to transfer to their son $65,000,000 in value of real estate (which had a $5,000,000 tax assessed value) without there being a change of ownership for property tax purposes.

3.5. ***Transfers of Real Estate From a Partnership to its Partners Can Trigger a Change of Ownership.*** A partnership (or an LLC) may want to transfer some or all of the partnership's real estate to the partnership's partners. For example, partners may wish to liquidate real estate from the partnership. Alternatively, during the life span of a partnership, the partnership may distribute the partnership's real estate to only certain partners. These real property distributions from a partnership can cause a change of ownership to the distributed real estate. To avoid such a change of ownership, all of the partnership's partners must receive distribution of the partnership's real property in the exact same ownership percentages as such partners' partnership

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

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interests.[22]

<u>Example</u>: Assume that the partnership is owned by four partners in equal percentages (25% by each partner). The partnership consists of four real properties, each property having an equal value. The partners now wish to liquidate the partnership, with each partner to receive 100% ownership of one real property on the liquidation. If each partner receives a 100% interest in one of the four real properties upon liquidation of the partnership, <u>there will be a change of ownership</u> as to each real property distributed to the partners, since each partner owns a 100% interest in their one real property received in distribution (not a 25% interest in each of the four real properties). Thus, the proportionate ownership of each of the four properties <u>changed</u> under §62(a)(2) on the properties' distribution, resulting in a property tax change of ownership for all four properties.

4. <u>HOW TO EXIT FROM REAL ESTATE</u>.

Below are discussed the tax consequences of the different ways that your clients can exit from their real estate investments.

4.1 ***<u>Sell the Real Estate and Recognize the Taxable Gain</u>***. Clients can sell their real estate and recognize the taxable gain. Currently, the maximum Federal income tax rate is 35% ordinary income and 15% long-term

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

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capital gain. However, this Federal tax rate is scheduled to rise to a 20% maximum long-term capital gain rate and 39.6% ordinary income tax rate on January 1, 2013. Additionally, commencing in 2013, there will be a new healthcare tax of 3.8% on passive investment income and on capital gains for high income earners.

When real estate is sold, there is both capital gains tax and a 25% tax on unrecaptured prior real estate depreciation. Starting in 2013, taxes on selling real estate are scheduled to increase under existing tax laws. First, the current maximum 15% Federal capital gains rate will rise to 20%. Second, the federal healthcare insurance tax will impose a new 3.8% tax on capital gains for high earners. Third, there remains the maximum 9.3% California income tax rate on all income including capital gains, plus an additional 1% tax for incomes over $1,000,000 under the ***California Mental Health Services Tax*** (or a maximum total of 10.3% California tax rate for high earners). California tax rates could increase even further under recent tax ballot measures. Thus, for the highest earning taxpayers, there is a potential aggregate Federal and California maximum 34.1% tax rate on long-term capital gains commencing January 1, 2013 (before taking into account the deduction for state income taxes or the effect of the alternative minimum tax). This increased capital gains tax imposes an increased tax for clients selling real estate.

For many California taxpayers, the ability to deduct state income taxes from their Federal taxes is effectively limited by the alternative minimum tax. Generally, when a client has a large amount of taxable gain (such as from the sale of real estate) there is a likelihood that the alternative minimum tax will apply.

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(a) **The New Healthcare Tax of 3.8% on Capital Gains**. Beginning in 2013, the ***Healthcare and Reconciliation Act of 2010****, §1411,* imposes a new 3.8% tax on net investment income, which includes net long-term capital gains. This new healthcare tax applies to taxpayers with modified adjusted gross income ("MAGI") over $200,000, and to married taxpayers filing jointly with MAGI over $250,000. The tax is calculated as 3.8% multiplied by the lesser of either the net investment income or the amount which the MAGI exceeds these threshold amounts. For estates and trusts, this new 3.8% tax applies at the much lower threshold point of when the estate or trust has income in excess of approximately $11,000. Clients can minimize this new healthcare tax as to their real estate by attempting to classify their real estate income as "active" trade or business income. However, clients must then avoid such "active" income being taxed as self-employment income. Additionally, consideration must be give to the possibility that proposed carried interest tax legislation could be enacted by Congress in the future, which may tax at ordinary income tax rates partnership distributions (including distributions representing proceeds from the sale of real estate) to a client, from partnerships that the client actively manages.

Note, that the "kiddie tax" concept does not apply to this new healthcare tax, so that passive investment income can be shifted to a child (who is below the MAGI threshold amounts) and avoid this 3.8% tax.

(b) **Taxes on Recaptured Income**. Assets sold in 2013 may be taxed at higher tax rates then capital gains rates. The tax on recaptured real estate depreciation remains at the 25% Federal rate. However, if there is personal property sold in connection with such real estate (such as movable refrigerators or movable stoves in a sold apartment building) the tax on the

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recaptured personal property depreciation is taxed at ordinary income tax rates which increase to a maximum 39.6% rate in 2013 (plus there will be California income taxes and the new healthcare tax on this recapture amount).

(c) **Tax Planning Strategies for Clients Closing the Sale of their Real Estate and Recognizing Taxable Gain.**

- **Close the Sale of the Real Estate in 2012.** If clients are considering a sale of their real estate on which they will be paying taxes, the client can consider trying to close that sale in 2012 in order to take advantage of the lower 2012 income tax rates.

- **If a Client Sells Real Estate in 2012 and Receives Back an Installment Promissory Note, the Client Will Pay at the Tax Rate in Effect in the Year that the Promissory Note's Payment is Received.** Thus, if a client receives a promissory note's payment after 2012, the client will be subject to the higher tax rates existing in those years. One planning idea is that if the client sells real estate in 2012 on an installment promissory note, the client can consider accelerating that promissory note's gain into 2012 (which would be at 2012's lower tax rates) by electing out of the installment sale treatment for the sale. This election out of installment sale treatment can be made up to the extended due date of the client's 2012 tax return (which will give the client until late in 2013 to decide whether or not to make this election out), leaving the client time to see what new tax laws Congress may enact.

4.2 If the Client Sells Real Estate, Consider Utilizing the Tax Free Exchange Provisions of Section 1031 to Defer the Client's Taxes on that Real Estate's Gain. Section 1031 tax free exchanges, which are

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discussed by another panel should be considered whenever a client sells real estate.

4.3 ***<u>Wait Until the Client Dies and the Real Estate Then Receives a Step-Up in Income Tax Basis</u>.*** When a client dies (or if their spouse dies when the real estate is owned as community property) the client receives a step-up in the income tax basis of their real properties[23] which they owned on the date of their death. The client can then proceed to sell that real estate and pay no tax on the appreciated value of the real estate.

If the real estate is owned in partnership or LLC form, then a §754 election can be made at the partnership entity level so that the real estate's income tax basis (the so-called "inside tax basis") is adjusted to the value of the deceased partner's outside income tax basis of their partnership interest (or membership interest for an LLC).

(a) **<u>Making of a §754 Election for Partnerships and LLCs to Increase Real Estate's Tax Basis</u>.** Partnerships and LLCs may make a §754 tax election. When a §754 election is made, the tax election then continues to apply during the year of the election and all subsequent tax years. The §754 election results in the basis of the partnership (or LLC) owned real estate being adjusted for the transfer of property (such as at death) to equal the basis of the deceased partner's outside tax basis, pursuant to §743.

Assuming that the fair market value of the partnership's (or LLC) owned real estate exceeds that real estate's income tax basis, a §754 election is tax advantageous. The result of the §754 election, along with the §743(b)

[23] The Adjustment in value is to date of death value, unless the alternate valuation date

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adjustment to the partnership's income tax basis of its real estate, is to put the deceased partner's (or member for an LLC) entity owned real estate in the same position as if the partner had purchased that real estate directly for its fair market value at date of death. Thus, for real estate that has appreciated in value, there is a step-up in its income tax basis so that the proportionate inside tax basis of that partnership's assets equals the deceased partner's outside income tax basis.

(b) **Basis Adjustments at Date of Death for Community Property.** Under §1014(b)(6), when an owner of real estate dies, not only does that deceased owner's community share of the real estate get adjusted to its date-of-death value, but the decedent's surviving spouse's one-half of the community property also gets adjusted to its date-of-date value. The result of §1014(b)(6) is that even though the surviving spouse's share of the real estate is not owned by the decedent, there is still a basis adjustment to both halves of the community at the first-to-die spouse's death. The surviving spouse also receives the benefit of an unlimited federal estate tax marital deduction for the deceased spouse's community interest in real estate left to that surviving spouse.

4.4 *Have the Real Estate Owner Contribute Their Real Estate to a New Venture Partnership with Other Investors*. The client's real estate can be contributed to a partnership or limited liability company tax free under §721 and the client can then receive back tax free partnership or LLC interests. Under the partnership tax rules, there is flexibility to distribute to the client a return of their capital and a preference on distributions without immediate taxable gain recognition.

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is elected (which alternate valuation date is the value 6 months after date of death).

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Example: Assume a landowner client desires to risk their land in a real estate development project. That client could contribute that land to a newly formed limited liability company. Other venture members could contribute cash. The client could have the preference of receiving back in cash the then fair market value of its land first, before any distributions to other members, along with the client receiving a preference on its unpaid land capital amount, and the client could even receive an additional developer's fee. The client's contribution of the land to the new limited liability company would be tax free under §721.

(a) **Must Avoid Gain Recognition Because of Shifting Liabilities**. If the contributed land is subject to a deed of trust, there may be a shift of liabilities which could produce a taxable gain to the contributing partner under §§752 and 731. The rules under the §752 Regulations state that a decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to that partner. [See Reg. §1.752-1(c).] Solve this tax issue by having the contributing partner continuing to be at risk for the indebtedness (and be allocated that debt for tax purposes) under the tax rules of §752.

(b) **Tax Issue of Disguised Sale.** If the partner that contributes real estate to a newly formed partnership shortly thereafter receives a cash distribution, there may be a "disguised sale" under §707, thereby creating gain to the contributing partner. Also, if there is a contribution of real estate to the partnership and shortly thereafter other property is distributed to that contributing partner for tax purposes or if the land is subject to a deed of trust, the transaction may be treated as a disguised sale between the contributing partner and the

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partnership. [See §707(a)(2).]

A contribution of the land encumbered by a deed of trust to a joint venture partnership generally will not be treated as a "sale" under the §707 disguised sale rules if that land is encumbered by a "qualified liability." A liability is a "qualified liability" if it is incurred by the contributing partner more than two years prior to the date that the partner agrees to transfer that land to the partnership and that liability has encumbered that land during that two year period. [See Reg. §1.707-5(a)(6).] Liabilities incurred within the prohibited two year period can still qualify as a "qualified liability" if it can be shown that the liability was not incurred in the anticipation of the transfer of the land to the partnership. There are other ways for a liability to be a "qualified liability" such as if it is allocable to certain capital expenditures of the partnership or if the liability was incurred in the ordinary course of a trade or business.

(c) **Tax Rule Requiring the Preservation of the Inherent Gain in the Contributed Property and the Allocation of that Gain to the Contributing Partner**. The gain and deductions with respect to the contributed land must be allocated among the partners to take into account the difference between the tax basis of that land and that land's fair market value at the time of contribution under §704(c). Thus, this "built-in-gain" on the sale of the contributed land will then be allocated to that partner that contributes that land to the partnership.

4.5 *Have the Real Estate Partnership Borrow Monies and Have the Partnership Then Use Those Borrowed Moneys to Purchase a New Property, Which the Partnership Then Distributes to the Existing Partner.* Many times a partner desires to withdraw from a partnership. By borrowing money at the partnership level, the tax goal is to have the partnership

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make distributions to its withdrawing partner in a tax free manner. The reason for this tax result is that under Federal income tax law, the borrowing of moneys and the receipt of loan proceeds is not taxable income. Under §752(a), a partner's outside partnership interest tax basis is increased by an increase in that partner's share of partnership debt. A partner does not have gain when that partner receives a distribution of property or money from a partnership under §731(a)(1), except to the extent that the amount of money (and debt relief under the §752 tax rules) that the partner receives exceeds that partner's outside tax basis. These tax rules result in a partner being able to receive tax free distributions of the proceeds of partnership indebtedness to the extent that that partnership debt is allocated to that withdrawing partner under §752.

(a) **Example of a leveraged partnership transaction**.

Assume that the partnership has owned a parcel of real estate ("Old Property") for 10 years and that Old Property has appreciated in value so that it now has a fair market value of $20,000,000, an income tax basis to the partnership of $6,000,000, and is encumbered by old indebtedness of $8,000,000. Assume that the partnership is owned by partners A, B and C, each an equal one-third partner.

The partnership could go out and purchase a new real property ("New Property") utilizing partnership cash proceeds and incurring new indebtedness allocated entirely to partner A under the §752 tax rules, and then distribute that New Property to partner A in complete redemption of partner A's partnership interest. Thus, the partnership would then be owned by only

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remaining partners B and C, and the partnership would continue to own the Old Property encumbered by the $8,000,000 debt. The redemption of A's partnership interest in exchange for the New Property would be tax free under §731 and A's income tax basis in the received New Property would be reflective of A's outside partnership interest basis under §732(b). Basically, the New Property, when distributed to A, would receive a reduced income basis (equal to A's outside partnership interest tax basis) to preserve the inherent gain that A had in A's outside partnership interest basis. This reduction in the New Property's tax basis could then be utilized to <u>increase</u> the partnership's Old Property tax basis if a §754 election is made, under §734.

Because the New Property's indebtedness is entirely allocated to A under §752, there should be no disguised sale problem under §707. The argument is that the incurring of the debt for the New Property is a debt financed distribution under Regulation §1.707-5(b). The IRS might argue that the debt financed property distribution to partner A (and the debt allocation to A under §752) should be ignored under the anti-abuse rules of Regulation §1.752-2(j) if in fact partner A does not bear any economic risk of loss. [See *Canal Corporation and Subsidiaries*, 135 T.C. 199 (2010).]

(b) **<u>Avoiding the Disguised Sale Rules</u>**. The disguised sale rules of §707(a)(2)(B) can apply to partnerships that borrow monies (thus causing gain recognition). These §707 disguised sale rules state that: (i) if a

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partner transfers money or other property to a partnership; (ii) there is a related direct or indirect transfer of money or other property by the partnership to that partner (or to another partner), and (iii) when viewed together, both transfers are properly characterized as a sale or exchange of property, the transfers will then be treated as either a transaction between the partnership and a non-partner, or a transaction between the partners acting as non-partners. Thus, the transaction could be treated as either a sale of the property to the partnership or a sale between partners. The Treasury Regulations promulgated under §707(a)(2)(B) employ various tests to see what constitutes a disguised sale. There are rebuttable presumptions under the §707 disguised sale rules. If the transfers occur within a two year period then the transaction is presumed to be a sale; and if the transfers occur more than two years apart, then the transaction is presumed not a sale. These presumptions, however, can be rebutted by a facts and circumstances test. In order to avoid the adverse tax result of the ***Canal Corporation*** case if moneys are extracted from the partnership by a loan to the partnership, then consider having the partner who receives those moneys to directly guarantee that loan under a commercially standard guarantee.

4.6 *Have the Client Create Liquidity for their Real Estate by Using an UPREIT Transaction*. The client could consider exchanging their real estate for interests in a publicly traded real estate investment trust ("REIT"). Converting into REIT interests offers the client the opportunity to convert their illiquid investment in real estate into liquid interests in a REIT. Owning an interest in a publicly traded REIT gives the real estate owner the ability to have marketable REIT shares which are traded on a national stock exchange.

Basically, a REIT is a special type of legal entity (which can be formed as a corporation or as a trust) that makes a special tax election to be taxed as a

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REIT under §856. If the legal entity satisfies the REIT requirements, it is then not subject to tax at the corporate level to the extent that its corporate level income is distributed to its shareholders or beneficiaries. The way that the REIT tax rules prevent a tax at the REIT corporate level is to provide for a tax deduction for the dividends paid to the REIT shareholders.

The historical problem of having real estate transferred to a REIT in exchange for REIT shares was that the real estate's transfer to the REIT created immediate taxable gain, even though the transfer satisfied on its face the §351 tax free transfer rules. Section 351 tax free treatment does not apply to property transferred to a corporation if that property is transferred to an "investment company" under §351(e). The §351(e) investment company rules prevent transfers of multiple investment real properties to a corporation if this would result in the diversification of the transferring party's interest and the transferee is a real estate investment trust. This means that a diversification of the real estate will result (and in turn trigger taxable gain) if two or more persons transfer non-identical real properties to the REIT corporation. Thus, a contribution by multiple persons of appreciated real estate to a REIT results in taxable gain to the contributors. This §351(e) "investment company" tax problem was solved through the UPREIT tax planning transaction.

(a) **Description of the UPREIT Transaction**. An "UPREIT" is an abbreviation for an "umbrella partnership real estate investment trust." In an UPREIT, the REIT forms a partnership (known as an operating partnership or an "OP"). The REIT serves as the general partner of the OP. The persons who contribute their real estate to the OP (which will include the client contributing their real estate to the OP) become the limited partners of this OP. The limited partners receive back in exchange for contributing their real estate to the OP,

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limited partnership interests in the OP which are referred to as "OP Units." Under the terms of the documentation, the limited partners are then permitted at a later date to exchange their OP Units for REIT common stock.

To prevent an immediate conversion into REIT shares by the OP Unit holders (which could result in a drop in the REIT stock price) there may be a prohibition for a specified lockout period on the OP Unit holders being able to convert their OP Units into REIT stock. Also, because the receipt of the REIT shares by the OP Unit holders will be a taxable event, the OP Unit holders generally will not undertake the exchange of their OP Units for REIT shares unless they are able to immediately sell their received REIT shares for cash.

(b) **The UPREIT Structure Has Been Approved in the Partnership Anti-Abuse Regulations**. Regulations promulgated under the partnership anti-abuse rules approve the UPREIT structure and indicate that the UPREIT structure will be respected under the substance-over-form tax rules. [Reg. §1.701-2(d) Ex. 4] Because of this Treasury Regulation and the fact that the UPREIT form has been regularly utilized in the past, the UPREIT structure has become a widely used transaction.

(c) **Technical Organizational Requirements of the REIT.** The REIT under the Internal Revenue Code's requirements must have at least 100 beneficial owners under §856(a)(5) and not more than 50% of the REIT shares for beneficial interests (based upon value) may be held by five or fewer individuals.[24] A REIT must also elect REIT status on its tax return for the taxable year.[25] Note that when an UPREIT is utilized, the OP Units may, in fact, be

[24] §§856(a)(6) and 856(h)(1).

[25] §856(c)(1).

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owned by five or fewer individuals. In other words, more than 50% of the OP Units could be owned by one or two people.

Each year, the REIT must meet two income tests: First, at least 95% of the REIT's gross income must consist of dividends, interest, rents from real property, gains on the disposition of stock and real estate not held for sale to customers in the ordinary course of business and income from foreclosure properties and the making of certain mortgage loans and other related items.[26] Second, at least 75% of the REIT's gross income must be derived from real property sources of a passive investment character, such as rents, mortgage interest, gains on disposition of real estate not held for sale to customers in the ordinary course of business, etc.[27] REITs need to be alert that the REIT could violate these gross income rules where the REIT is receiving income from services furnished to tenants.

REITs must also satisfy an asset test which includes that at least 75% by value of the REIT's total assets must be real estate assets, cash assets and government securities.

A REIT must on an annual basis make distributions, to qualify for a deduction of dividends paid, at least equal to the sum of: (i) 90% of REIT taxable income for the year and (ii) 90% of the excess of net income from foreclosure property over the tax on the income, less any "excess" non-cash income. Certain excess noncash income is deducted from this calculation.[28]

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[26] See §856(c)(2).

[27] See §856(c)(3).

[28] See §857(a)(1).

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(d) **<u>The OP Unit Holders Can Convert Their OP Units Into REIT Shares Tradable on a Stock Exchange</u>**. By allowing the OP's contributing real estate partners to be able at a later date to convert their OP Units into tradable REIT shares gives these OP Unit holders (the contributing partners) effective liquidity in their real estate investment. When these OP Unit holders elect to convert their OP Units into tradable REIT shares, this conversion will result in taxable gain. The gain is equal to the difference between the REIT shares received by the OP Unit holders and the OP Unit holder's tax basis in their OP Units. Because of the strict tax rules that apply to REIT share ownership, the REIT, in many cases, is given the option to pay the OP Unit holders in cash rather than in REIT stock when the OP Unit holder elects to convert.

(e) **<u>Tax Issue of the Disguised Sale Rule</u>**. The Unit holder that contributes their real estate to the OP will want to avoid the §707 disguised sale rules when they convert their OP Units into REIT shares. If the disguised sale rules apply then it could be deemed that the Unit holders had taxable gain on the date of their real estate's contribution to the REIT's OP (rather than at the later date when that Unit holder converts their OP Units into REIT shares). To avoid the application of the disguised sale rules, the contributing Unit holders could wait at least two years to convert their OP Units into REIT shares. This would give the contributing Unit holders the benefit of the two year presumption rule under the disguised sale rules of §707.

(f) **<u>Tax Issue of the Difference Between the Fair Market Value of the Contributed Real Estate and that Contributed Real Estate's Income Tax Basis</u>.** When the real estate owner contributes their appreciated real estate to the OP, there may be a difference between that real estate's fair market value

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and its income tax basis.[29] Section 704(c) requires that this difference be allocated to the contributing partners (that is, the partners that contributed their real estate to the OP) when the gain on that contributed real property is recognized. Additionally, the allocation of amortization and depreciation deductions among the OP Unit holders must take into account this difference between fair market value and income tax basis of the contributed real property. The §704(c) rules require that the <u>non-contributing Unit holder partner</u> (that is, that partner in the OP that did not contribute that specific real property to the OP) be put into a tax position that it would have been had that contributed real property had a tax basis equal to its fair market value on the date of its contribution to the OP. In other words, those non-contributing partners must be allocated amortization and depreciation deductions as if that noncontributing partner had actually bought that real property for its fair market value on the date of its contribution to the OP. Under §704(c) and the Regulations thereunder, three tax accounting methods are acceptable for this amortization/depreciation calculation: the traditional method; the traditional method with curative allocations; and the remedial allocation method. When a Unit holder contributes their real estate to the OP, it is important for that Unit holder to calculate the different §704(c) accounting methods and the tax effects that each accounting method will have on them in order that such Unit holder can contract with the REIT for the most favorable §704(c) method.

(g) **<u>The Contributing Partner Will Want to Have the REIT and OP Covenant that the OP Will Not Dispose of the Real Estate</u>.** The REIT as the general partner of the OP can control the sale of the OP's real properties and the OP's property's refinancings. This power could be exercised by the REIT to produce adverse tax consequences to the contributing partner/OP Unit holder

[29] The so called "704(c) gain."

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because of the §704(c) gain rules, described above. For example, if the OP's real properties were sold, then under §704(c) that sale's gain could be allocated back to the contributing OP Unit holder that desired to defer the gain. To solve this tax problem, a covenant could be negotiated whereby the OP is prohibited for a specified time period from selling that OP Unit holder's contributed real properties. Alternatively, the OP and the REIT could indemnify the contributing OP Unit holder for the negative tax consequences should the OP sell that OP Unit holder's contributed real estate within a prohibited selling period.

(h) **Tax Issue with Contributing Encumbered Real Estate to the OP.** Real estate contributed to an OP in many cases is encumbered with debt. This debt may be recourse or non-recourse indebtedness. Under the partnership tax rules, when the real estate is contributed to the OP, a decrease in a partner's share of liabilities on a property's contribution is deemed to be a distribution of cash to that contributing partner which could result in gain recognition under §731(a). In other words, the reduction in the OP Unit holder's share of the OP debt is treated as a cash distribution to that Unit holder by the OP. If under §731, the decrease in the contributing OP Unit holder's share of indebtedness exceeds that Unit holder's outside basis in its OP partnership interest then gain recognition may result. This §731 calculation means that it is important that the contributing OP Unit holder retain during the OP's operation enough OP indebtedness under the §752 tax rules so that they avoid gain recognition. For example, to keep enough debt allocated so as to not have §731 gain, the contributing OP Unit holder may want the OP to not pay off the indebtedness on their contributed real estate. The OP Unit holder may instead want the OP and REIT to covenant that the OP will maintain a minimum overall level of indebtedness. Alternatively, the OP Unit holder could guarantee a certain amount of indebtedness of the OP to receive allocation of debt under the

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§752 tax rules.

4.7 ***Use the Client's Capital Losses to Offset that Client's Gain on the Sale of Appreciated Real Estate*****.** When selling appreciated real estate the client can offset that real estate's recognized gain against their net capital losses, either losses generated in the year of sale or losses carried forward to the year of sale. Additionally, individuals (or married couples) may deduct up to $3,000 per year of unused net capital losses under §1211(b) against their ordinary income. Unused net capital losses may be carried forward by the client indefinitely (and utilized to offset capital gains in future years or up to $3,000 of ordinary income) under §1212(b).

(a) **Tax Rates on Capital Gain.** Each year, the client calculates their net long-term capital gain or long-term capital loss, as well as their net short-term capital gain or short-term capital loss. If in that year the net long-term capital gain exceeds any net short-term capital loss, the result is a net capital gain. Remember that the real estate gain attributable to recapture of prior real estate depreciation is still subject to a tax rate up to a maximum 25% rate under §1(h)(1)(d). Net capital gain on the sale of that real estate is taxed in 2012 at a maximum federal capital gain rate of 15%. California taxpayers pay capital gain taxes at the taxpayer's regular California tax rate.

(b) **Section 1231 Gains and Losses**. Normally, the rental of real estate becomes a "trade or business" for §1231 purposes. If this results, then the sale of such real estate held for more than one year gives rise to a §1231 gain or a §1231 loss, as the case may be. Real estate not qualifying as a "trade or business" under §1231 will result in its gains and losses becoming capital gains or capital losses. The courts have generally found that the rental of real

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estate to generate rental income constitutes a trade or business resulting in §1231 applying.

Taxpayers are required to combine their §1231 gains and §1231 losses for each year. If the result of such combination and netting is a net §1231 loss, that loss is deductible in full as an ordinary deduction under §1231(a)(2). If the result of the netting is a §1231 gain, then the taxpayer must treat that §1231 gain as an ordinary gain to the extent of §1231 losses, and the taxpayer then treats any remaining net §1231 gain as long-term capital gain (taxed in 2012 at a maximum federal 15% rate). [See §1231(c).] For net capital gain under §1231 for that year, the taxpayer will also have to pay a 25% maximum tax on the real estate's depreciation recapture under §1(h)(1)(d).

This Article contains general information on tax issues. Because each client's tax and factual situation is unique, nothing in this Article should be deemed advice on a specific transaction or to a specific person. Please contact Robert A. Briskin at (310) 201-0507 or by e-mail at rbriskin@rablegal.com for legal and tax advice.

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