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MEMORANDUM

Income Tax Planning and Estate Planning for Negative Capital Accounts: The Entity Freeze Solution

by Steve Breitstone, Esq.
Meltzer, Lippe, Goldstein and Breitstone, LLP
Mineola, New York
and Jerome M. Hesch, Esq.*
Carlton Fields, P.A.
Miami, Florida

Abstract. For individuals owning a real estate interest with a gross value in excess of the mortgages on the property, but the mortgage liabilities are in excess of the income tax adjusted basis for the real estate, this article will examine how to use the preferred partnership freeze under §2701 to eliminate the phantom gain without an estate tax cost and still shift all future appreciation in value out of the estate without an estate tax and with a minimal or no gift tax cost. This article will explain how the preferred partnership freeze technique uses the required partnership allocation rules under Subchapter K to obtain an income tax-free, step-up in basis at death for all of, or substantially all of, the built-in gain inherent in the real estate while exposing only a nominal amount to the estate tax.

The primary objective of the successful estate planning technique is to transfer an asset with potential appreciation in value out of the estate and at the same time freeze the amount subject to the estate tax at the asset's current value at the time the technique is implemented. This is true whether the freeze technique is an outright gift, an installment sale, a private annuity sale or a GRAT. The income tax drawback of these commonly used freeze techniques is that the asset is no longer in the decedent's gross estate at death. As a result, the asset cannot obtain an income tax-free basis step-up at death. The outright gift is a freeze because the taxable gift is an "adjusted tax gift," and the estate tax, before application of the unified credit, is computed on the sum of the adjusted taxable gift and the taxable estate. An installment sale to an irrevocable grantor trust replaces the asset sold with a prom-

issory note, and either the note or the principal payments received on the note are included in the individual gross estate. The GRAT is essentially a sale because the individual received an annuity equal in value to the asset transferred to the GRAT, and the annuity payments received are included in the individual's gross estate. For the outright gift, the individual's income tax basis is taken over by the donee, a "carryover basis," and because the gifted asset is not included in the individual's gross estate, there cannot be an income tax-free step-up in basis at death. If the individual dies after the installment note is paid in full, the grantor trust has the same carryover basis. Likewise, for the GRAT, the trust also has a carryover basis in the asset transferred to the GRAT. Consequently, all of the potential income tax gain in the asset shifted out of the individual's gross estate remains.

Because an estate freeze is principally designed to shift only future appreciation out of the individual's gross estate, the better approach for a highly appreciated asset is to use a technique that can obtain the income tax-free step-up in basis at death for the gain inherent in the frozen value. And, where the appreciated asset is subject to a liability, one should use a technique that retains that portion of the asset subject to the liability in the individual's gross estate as the amount exposed to the estate tax is the gross value of the asset less the liability encumbering the asset (i.e., the equity in the asset).

The often overlooked preferred partnership freeze is designed to accomplish this objective. And, in §2701, Congress provided a safe-harbor roadmap for structuring the preferred partnership freeze (the "preferred partnership freeze" or the "entity freeze"). In effect, this entity freeze can shift future appreciation without the income tax cost that comes with carryover basis. To maximize the estate tax savings, the entity freeze should be considered in situations involving assets encumbered by liabilities. However, before choosing the entity freeze, a comparison must be made with the litany of alternative freeze methods. It is essential to select the right freeze method for the right situation. As will be explained below, in the appropriate circumstances the entity freeze technique can be extremely compelling because it can avoid the income tax deficiencies of the other freeze techniques.

Perhaps the most compelling fact pattern where the entity freeze is advantageous is a highly leveraged asset with a low adjusted income tax basis, typically existing in real estate held in a partnership or in a limited liability company characterized as a partnership for federal income tax purposes. For leveraged real estate, the entity freeze is typically the only method that can eliminate the negative capital account or phantom gain upon the death of the holder with little or no estate tax exposure.

* Mr. Hesch is also an Adjunct Professor in the Graduate Program in Estate Planning at the University of Miami, and the Director of the 39th Annual Notre Dame Tax and Estate Planning Institute, which will be held on Sept. 20 and 21, 2012.

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Where the liabilities encumbering real estate exceed the income tax basis for the assets, the real estate is commonly referred to as *negative basis property*.¹ If the real estate with liabilities that exceed basis is sold, the amount of the gain on the sale is determined by treating both the cash proceeds and all of the liabilities as part of the sale price, thus giving rise to what is commonly referred to as *phantom gain*.² As the phantom gain can be eliminated if the negative basis asset is included in the gross estate upon the death of the owner,³ the estate planner needs to take this into account when considering an estate planning technique designed to shift this asset out of the individual's gross estate.

HISTORY OF THE ENTITY FREEZE

Prior to the enactment of §2701⁴ in 1990 as part of the Chapter 14 regime, entity freeze techniques were referred to as "capital freezes."⁵ This term was a reflection of the fact that under state of the art planning of that time, no capital was needed to be transferred for the preferred partnership freeze to accomplish the intended objectives. In effect, one could retain the principal and shift the income from the principal without transferring any value under the gift tax. Prior to the enactment of §2701, it was much easier than it is today to simply "shift" income to the next generation. There was no need to freeze what could simply be shifted.

The capital freeze first involved the recapitalization of a business entity (whether a partnership or a corporation) into separate classes of ownership interests. After the recapitalization there would be a preferred interest and a common interest. The preferred interest would be entitled to a priority return on its capital and a liquidation preference so that the preferred interest would be entitled to a priority return of capital upon the occurrence of a liquidity event. However, unlike under current law, there was no need to provide for preferred dividends or preferred distributions that

would actually be paid. The preferred dividends or the priority return could be non-cumulative so that if not paid in one year (or for several years) the holder of the preferred interest would not be entitled to a makeup distribution in future years. The non-paid preferred dividend or priority return would be lost — or perhaps more aptly put — shifted to the holders of the junior equity. Moreover, the rights to a liquidation preference could be illusory. Under the entity's organizational documents, the right to the liquidation preference could lapse under certain circumstances, such as upon the death of the holder of the preferred interest. Likewise, the holder of the preferred interest could have a lapsing right to "put" its interest to the entity for a fixed price or to "call" its capital from the entity in a redemption. However, these rights would seldom be exercised in the family context. They were mainly inserted into the transaction as window dressing so appraisers would attribute all or almost all of the value to the preferred interest which would reduce or, more likely, negate a gift upon the gift of the common interest to a trust for the younger generations.

Within the family context, there thus existed the opportunity to shift all income and all appreciation in value to the holders of the junior equity interests as they would benefit from the nonpayment of dividends on the senior preferred, the lapsing liquidation rights, etc. While an appraisal of the preferred interest would recognize these rights as enhancing the value of the preferred interest, that value would be illusory. It was typically the case that an appraisal could value the preferred interest at 100% of the value of the entity leaving no value to be allocated to the junior interest. Any option value to the junior interest would typically be ignored even though it constituted real economic value. Outside of the family context the option value was meaningful because it represents the rights of the holders of the junior equity to participate in the growth in value or upside of a business enterprise. As a result of the manner in which the junior interest would have been valued under pre-chapter 14 authorities, the transfer of the common interest would have little to no gift tax value — even though in reality, its represented a significant shifting of wealth to the holders of the junior equity.

Today, there are a number of provisions set forth in Chapter 14, mostly in §2701, specifically designed to preclude this type of planning. Section 2701 was enacted to preclude these perceived abuses involving entity freezes that were condoned by case law.⁶ These cases involved, inter alia, rights belonging to the senior preferred interest holders that lapsed upon death,

¹ Liabilities in excess of adjusted tax basis can occur where the property is fully depreciated, especially when a cost segregation study has been implemented, the present property is the successor in a line of like-kind exchanges under §1031 or the owner has financially realized upon the appreciation in value by a series of income tax-free refinancing as loan proceeds are not taxable gain. *Woodsam Associates, Inc. v. Comr.*, 198 F.2d 357 (2d Cir. 1952).

² See *Comr. v. Tufts*, 461 U.S. 300 (1983), and *Crane v. Comr.*, 331 U.S. 1 (1947).

³ *Crane v. Comr.*, 331 U.S. 1 (1947).

⁴ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

⁵ See the Revenue Reconciliation Act of 1990, passed by Congress on Oct. 27, 1990, and signed by President Bush on Nov. 5, 1990.

⁶ See *Harrison Est. v. Comr.*, 42 T.C.M. 1307 (1987); *Watts Est. v. Comr.*, 51 T.C.M. 60 (1985), *aff'd*, 823 F.2d 483 (11th Cir. 1987); *Boykin Est. v. Comr.*, 53 T.C.M. 345 (1987).

but which were taken into account in determining the value of the preferred interest.⁷ Section 2701 has reigned in many of these types of abuses. The §2701 rules that eliminated these abuses are in the form of what rights the preferred interest must have so that the gift of the common interest will have a statutorily minimum value for gift tax purposes. By setting for the requirements for the preferred equity interest, §2701 now provides a safe harbor set of rules that if followed, eliminate all of the uncertainty surrounding the preferred partnership freeze.

Another development that indirectly impacted the use of the entity freeze is §1274, which requires the use of the Applicable Federal Rate (the “AFR”) for all deferred payment sales. Section 1274 was enacted in 1984 to combat abuses involving low-interest purchase money indebtedness used on property acquisitions (i.e., seller-provided financing) to either (i) inflate depreciation deductions and thus increase the tax shelter resulting from the purchase of income producing properties or (ii) convert interest income taxable at ordinary income tax rates into capital gains. Prior to the enactment of §1274, artificially low interest rates could be charged so that the same level payment would support a higher nominal purchase price for such property. The higher nominal purchase price resulted in disguising interest as principal, thus converting ordinary income into capital gains and in inflated depreciation deductions which could be made available to offset unrelated income — thus a tax shelter.

Although §1274 was intended to govern income tax deferred payment sales, it had a positive impact on freeze techniques used for estate planning that was likely unintended. This impact has been amplified in the current exceptionally low interest rate environment. As the AFR is determined by reference to the one-year Treasury bill rate, it is always a below-market interest rate, even in high interest rate environments. For example, a father could sell a \$1,000,000 corporate bond paying 3.0% interest to a son, and take back the son’s 9-year, interest only, promissory note paying only 0.9% in satisfaction of the entire selling price, thus allowing the son to keep the excess \$21,000 each year without any gift tax.

Because §1274 only applies to deferred payment sales, the AFR is not used to determine the priority return that must be paid on a preferred equity interest. Instead, the preferred return that must be paid in the entity freeze is determined by market forces. Other freeze techniques may rely on the AFR, which is typi-

⁷ See TAM 8510002 (11/26/84) and TAM 8401006 (9/28/83) (advising that decedent taxpayer’s voting control should be taken into account in valuing stock for estate tax purposes where the taxpayer owned voting shares in a family-owned corporation that became nonvoting at his death).

cally a far lower rate. Thus, GRATs must use the §7520 rate (which is 120% of the midterm AFR) in determining the annuity payments that must be made to the grantor. Installment sales to intentional grantor trusts must pay interest at not less than the AFR. The AFR will almost always be lower than the market rate of return payable on a preferred interest.⁸

The availability of the unrealistically low “hurdle” rates associated with other freeze techniques, such as GRATs and installment sales to grantor trusts, makes those techniques far more advantageous in many, but not all, situations. The situations where those techniques may not work as well as the entity freeze are explored below.

IMPLEMENTATION OF THE PREFERRED PARTNERSHIP FREEZE

The following example is designed to illustrate that, in situations where the amount of liabilities in excess of basis is significant, the income tax savings can far exceed the estate tax cost of including the asset in the individual’s gross estate and having to pay the estate tax.⁹

Example: Senior owns a commercial office building held for rental. Senior purchased this property in 1984 for \$20,000,000 and allocated \$16,000,000 of the purchase price to the building. Senior was able to depreciate the entire amount allocated to the building over 18 years using an accelerated method of depreciation. Moreover, over the years Senior was able to take substantial funds out of the building tax-free by means of periodic mortgage refinancing. At present, the gross value, mortgage liability and adjusted tax basis for the building are:

Gross value	\$ 54,000,000
Adjusted basis	4,000,000
Mortgage	44,000,000
Equity	10,000,000 ¹⁰

Note: Because an accelerated method of depreciation was used, all of the \$16,000,000 of depreciation

⁸ Rev. Rul. 83-120, 1983-2 C.B. 170, provides guidance by providing that a market based approach must be used to determine the priority return for a preferred entity interest. It is typical that the yield on a preferred interest as of July 2012 can be in the 6% to 9% range when the long-term AFR for July 2012 is only 2.30%. Rev. Rul. 2012-20, 2012-27 I.R.B. 1.

⁹ Of course, this analysis must also take into account the decedent’s other assets as the advantages of eliminating the phantom gain, and any additional gain, may be negated by the estate tax cost of these other assets.

¹⁰ The \$10,000,000 equity is determined by offsetting the \$54,000,000 gross value by the \$44,000,000 mortgage liability.

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on the building is recaptured as §1245 ordinary income. Section 1245(a)(5), as in effect before the Tax Reform Act of 1986, treated all buildings using an accelerated method and an 18-year recovery period as §1245 recovery property.¹¹

If Senior died in 2012, when the maximum estate tax rate is 35%, and assuming Senior's domicile at death was a state with no estate tax (and assuming no available credit against the estate tax under §2010), the estate taxes (35% × \$10,000,000 equity) would be \$3,500,000. And, the estate's income tax basis in the commercial office building would be stepped up, income tax-free, to \$54,000,000. If the value of the land is \$14,000,000, then the estate, or other successor-in-interest, can depreciate the \$40,000,000 allocated to the depreciable building over 27½ (for residential rental buildings) or 39 years (for commercial buildings) (and quicker if a cost segregation study were used).¹²

Instead, Senior is alive and decides to sell the property in 2012. Because the property is located in New York City, the combined state and city income tax rate is 10%. If Senior sells the real estate for \$54,000,000 (after all selling expenses are taken into account), the \$50,000,000 gain realized on the sale will be taxed as follows:

<i>Gain</i>	<i>Combined income tax rate</i>	<i>Federal and state income taxes</i>
\$16,000,000 ordinary income	45%	\$7,200,000
\$34,000,000 capital gain	25%	\$8,500,000
Total income taxes		\$15,700,000

The advantage of being subject to the federal estate tax is the complete elimination of the \$50,000,000 of gain, including the \$40,000,000 of phantom gain (excess of liabilities over adjusted tax basis) without exposing any of the phantom gain to the estate tax. So, at an estate tax cost of only \$3,500,000, applying the federal estate tax eliminates \$15,700,000 of income taxes if the property is to be sold and no like-kind exchange is used.

As is readily apparent, selling the building is not financially advisable. The \$10,000,000 of net sale proceeds after the payment of the mortgage would be far less than the \$15,700,000 of income taxes on the gain. Thus, there are many properties where the owners are reluctant to sell because the income taxes on the phantom gain can result in a negative cash position. The owners of negative basis real estate are inclined to

hold the property until they die to eliminate not only the phantom gain, but all of the built-in gain and are willing to pay the estate tax on the real estate in order to obtain the income tax-free basis step-up at death.

Even if the property is not sold by Senior's estate, and continues to be operated as a rental property, the step-up in basis at Senior's death creates an additional \$50,000,000 of basis that can be taken as depreciation deductions over 39 years (and over 27½ years if the depreciable building is a residential rental property and more rapidly for a portion if a cost segregation study is used). Because the depreciation deductions are ordinary deductions, those deductions will save an additional amount in taxes over the depreciable recovery period. If \$40,000,000 is allocated to the depreciable building, and the combined effective income tax rate is 45%, the income tax saved by \$40,000,000 of depreciation deductions is \$18,000,000.

Even for buildings placed in service after 1986, the gain attributable to the straight-line depreciation on the building is taxable at a federal rate of 25% as "unrecaptured §1250 gain."¹³

The estate tax disadvantage of holding the real estate until death is that not only is the current value included in the gross estate, but all future appreciation in value is also exposed to the estate tax. And, given that real estate values today are generally depressed, many building owners feel that their real estate holdings will eventually rebound in value. In fact, the property in our example was worth \$64,000,000 in 2007 just before the market crash.

So, the objective is how to include the current \$10,000,000 of equity in the gross estate, obtain an income tax-free basis step-up for the value offset by the \$44,000,000 and shift all future appreciation in value out of the gross estate? The solution is the preferred partnership freeze described next.

Use of the Preferred Partnership Freeze

Although the above example assumed that Senior owned the real estate as an individual, today all real estate is generally owned in partnership form, either as a limited partnership or as a limited liability company. Using the same example as above, assume for illustrative purposes that the real estate is owned by a partnership and for simplicity purposes assume that the partnership is a limited partnership with Senior as the sole limited partner and that the general partner is a management company that receives a guaranteed payment in return for services. Thus, the partnership balance sheet is as follows:

¹¹ P.L. 97-34, §204(c), as amended by P.L. 99-514, §201(d)(11). Section 1245(a)(5) is still applicable for property placed in service between 1981 and 1986.

¹² §168(c).

¹³ §1(h)(1)(D)(i).

PARTNERSHIP BALANCE SHEET

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>	<u>Value</u>
Real estate	\$4,000,000	<u>\$54,000,000</u>	Mortgage	\$44,000,000
			<u>Capital</u>	
			Limited partner	\$10,000,000
			General partner	<u>Zero</u>
Totals		<u><u>\$54,000,000</u></u>		<u><u>\$54,000,000</u></u>

During 2007, when the real estate was worth \$64,000,000, the partnership refinanced the real estate for the current \$44,000,000 mortgage loan, using \$32,000,000 of the refinancing to pay off the old mortgage and distributed the remaining \$12,000,000 as an income-tax-free distribution to Senior.

Senior intends to hold the real estate (actually the partnership interest) until his death so as to receive an income-tax-free set-up in basis, thereby eliminating all of the \$50,000,000 gain, including the \$40,000,000 of phantom gain (the so-called negative basis). In addition, Senior expects the value of the building to rebound to its prior level, especially because the building is 100% occupied and is located in an area where commercial rentals are expected to increase in the long term. Because of Senior's concern with the phantom gain, Senior has done no estate planning for this partnership interest and intends to hold the real estate (actually the partnership interest in the partnership that owns the property) until his death. The disadvantage of this approach is that all subsequent appreciation will be included in Senior's estate at death.

Using a preferred partnership freeze under §2701, Senior can shift all future appreciation in value without any gift or estate taxes and still obtain an income-tax-free step-up in basis at death for all or 90% of the phantom gain as well as the remainder of the built-in gain.

Pursuant to §2701, Senior will recapitalize the partnership into preferred and common limited partnership interests. The tax benefits of the preferred partnership structure are two-fold. First, all subsequent appreciation in excess of the current \$54,000,000 of value must be allocated to the common interest and the common interest can be shifted out of Senior's estate without any estate tax on that future appreciation. Second, by retaining a preferred partnership interest, 90% of the phantom gain, and up to 90% of the "equity" gain, can receive an income-tax-free step-up in basis at death.

Alternative Solution #1. Convert the \$10,000,000 of partnership capital held by the limited partner into a preferred capital account representing 90% of the capital and a common capital account representing 10% of the capital.

PARTNERSHIP CAPITAL ACCOUNTS

<u>Partner</u>	<u>Tax Basis¹⁴</u>	<u>Gross Value</u>	<u>Liability¹⁵</u>	<u>Phantom Gain</u>	<u>Capital Account</u>
Preferred (90%)	\$3,600,000	\$48,600,000	\$39,600,000	\$36,000,000	\$9,000,000
Common (10%) ¹⁶	<u>\$400,000</u>	<u>\$5,400,000</u>	<u>\$4,400,000</u>	<u>\$4,000,000</u>	<u>\$1,000,000</u>
Totals	<u><u>\$4,000,000</u></u>	<u><u>\$54,000,000</u></u>	<u><u>\$44,000,000</u></u>	<u><u>\$40,000,000</u></u>	<u><u>\$10,000,000</u></u>

¹⁴ §704(c). The regulations require that all of the built-in gain must be allocated to the partners who were partners at the time the built-in gain occurred, commonly referred to as a "reverse §704(c) allocation." Regs. §§1.704-1(b)(4)(i), -3(a)(6)(i).

¹⁵ Regs. §1.752-3. Likewise the partnership liability allocation regulations require that the liabilities creating the reverse §704(c) allocation also be allocated to the same partner who was allocated the reverse §704(c) gain. Regs. §1.752-3(a)(2).

¹⁶ Section 2701(4) requires a minimum valuation for the junior or common interest to be at least 10% of the values for all of the capital accounts.

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Senior retains ownership of the preferred interest and disposes of the common interest by a transfer of the common interest to a grantor trust¹⁷ for the benefit of junior family members. By making a gift to a grantor trust, there is no gift for income tax purposes and therefore no income tax liability shift.¹⁸ Alternatively, the disposition of the common interest can be

¹⁷ If the gift is to Junior directly, or to a non-grantor trust, then there would be a liability shift for income tax purposes, and gain would be realized and recognized to the extent the liability exceeded the basis in the gifted asset. See §§1001 and 1015. In other words, this would be a part-sale, part-gift, causing the realization and recognition of \$4,000,000 of gain (\$4,400,000 of liability in excess of \$400,000 of basis for the common interest). Thereafter, the donee's basis in the common interest would be \$4,400,000. See, e.g., *Guest v. Comr.*, 77 T.C. 9 (1981); *Ebben v. Comr.*, 783 F.2d 906 (9th Cir. 1986); *Diedrich v. Comr.*, 457 U.S. 191 (1982). See also Rev. Rul. 81-163, 1981-1 C.B. 433.

¹⁸ Cf. Rev. Rul. 81-98, 1981-1 C.B. 40 (gift of installment note to a grantor trust is not an early disposition under §453B); Rev. Rul. 85-13, 1985-1 C.B. 184; and PLR 200434012 (4/23/04) (fol-

Partner	Tax Basis	Gross Value
Preferred (90%)	\$3,600,000	\$48,600,000

The total potential gain in the preferred interest is \$45,000,000 (of which \$36,000,000 is phantom gain).

Using the \$9,000,000 value (no valuation discounts are taken) for the preferred partnership interest included in the gross estate, the estate's income tax basis in the preferred partnership interest will be \$48,600,000 (includes the \$39,600,000 of liabilities allocated to the preferred interest). Because the estate's \$48,600,000 basis (outside basis) in its partnership interest exceeds the \$3,600,000 share of the partnership's basis (inside basis) in the real estate, the §743(b) special basis adjustment is \$45,000,000, thus eliminating 90% of the phantom gain, and 90% of the remaining gain, at a very modest estate tax cost. And, all of the future appreciation has been shifted to the common interest.

Partner	Tax Basis	Gross Value
Common (10%)	\$400,000	\$5,400,000

Alternatively, Senior can sell the common interest to a grantor trust for a \$1,000,000 installment note (again, assuming no valuation discounts). If Senior dies while the grantor trust's entire \$1,000,000 note obligation is outstanding, upon Senior's death, the trust becomes a non-grantor trust for federal income tax purposes. Upon the conversion of the trust, which occurs simultaneously with the grantor's death, Senior is treated for income tax purposes as transferring the encumbered common partnership interest by reason of death. Because a transfer of property subject to a li-

by an installment sale to the grantor trust. Under the partnership agreement, all subsequent appreciation in the value of the real estate is allocated to the common interest.

When Senior dies, the preferred limited partnership interest is an asset included in Senior's gross estate. As the preferred interest is a limited partnership interest, it is eligible for a valuation discount. But, for now, assume that the preferred limited partnership interest is valued in Senior's gross estate at \$9,000,000 (no valuation discounts are taken) when Senior dies. That preferred partnership interest has the following characteristics:

lowed Rev. Rul. 85-13, holding that there was no income tax realization event for income tax purposes upon the sale of an appreciated asset to a grantor trust). See Hesch and Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Estates, Gifts and Trusts J.* 3 (1/14/99).

Liability	Phantom Gain	Capital Account
\$39,600,000	\$36,000,000	\$9,000,000

Using a 45% estate tax rate, the estate taxes on \$9,000,000 are \$4,050,000. This estate tax cost is far less than the income taxes on the \$45,000,000 of income tax gain eliminated by including the preferred interest in the gross estate.

If there was a gift of the common interest to a grantor trust, the common interest is not included in the gross estate and the \$4,400,000 of gain inherent in the common interest at the time Senior transfers it by gift remains exposed to the income tax.¹⁹ That common partnership interest has the following characteristics:

¹⁹ §§671-677.

Liability	Phantom Gain	Capital Account
\$4,400,000	\$4,000,000	\$1,000,000

ability by death is not an income tax realization event, none of the \$4,000,000 built-in gain inherent in the common interest is reported, and the trust, which is now a non-grantor trust, takes a \$5,400,000 income tax basis in the common interest, creating another \$5,000,000 §743(b) special basis adjustment.²⁰

²⁰ When the grantor dies with the promissory note outstanding, the promissory note is an asset included in the grantor's gross estate at its fair market value. The contentious issue is whether there is a taxable transfer at the time of death for income tax purposes

by the grantor to the family trust of the property originally "sold" to it, because it is transferred subject to the obligation of the promissory note. The better view is that the transfer at death should not result in recognition any more than a transfer of property to the estate subject to an obligation owed to a third party secured by a mortgage in an amount in excess of the decedent's basis in the property results in gain recognition. Death is simply not a realization event. Thus, because the termination is at death, the decedent does not realize taxable gain on any excess of the balance of the tax amount of the note over the basis of the property transferred. Similarly, there is no income in respect of a decedent (IRD) under §691 because there was no gross income prior to death. IRD is defined as income realized while the decedent was alive but not reported while alive because of the decedent's method of accounting. Because the initial "sale" to the family grantor trust was not a realization event for income tax purposes, it cannot satisfy the terms of §691(a). Several commentators agree that the termination of grantor trust status as a result of the grantor's death while the promissory note is outstanding does not result in the realization of the gain inherent in the assets initially transferred to the grantor trust. See Gans and Blattmachr, "No Gain at Death," 149 *Trusts & Estates* 34 (Feb. 2010); Aucutt, "Installment Sales to Grantor Trusts," 4 *Business Entities* 28 (March/May 2002); Blattmachr, Gans and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 *J. of Tax'n* 149 (Sept. 2002); and Hesch and Manning, "Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements," 24 *Tax Mgmt. Estates, Gifts and Trusts J.* 3, 21-26 (1/14/99). Other commentators have reached a different conclusion without addressing the application of the principle developed by the Supreme Court in *Crane v. Comr.*, 331 U.S. 1 (1947), that death is not an income tax realization event when an encumbered asset is transferred by reason of death. See Cantrell, "Gain Is Realized at Death," 149 *Trusts & Estates* 20 (Feb. 2010); Dunn and Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," 95 *J. of Tax'n* 49 (July 2001); Peebles, "Death of an IDIT Noteholder," 144 *Trusts and Estates* 28, 32-33 (Aug. 2005);

If the preferred limited partnership interest is discounted, the discount does not change the amount of phantom gain that can be eliminated by inclusion of the preferred interest in the gross estate. As the discount only reduces the value of the preferred limited partnership interest included in the gross estate, the discount only reduces the income tax step-up in basis for the value of the \$9,000,000 of equity in the preferred interest.²¹ For example, if the preferred interest was valued in the gross estate at a discounted value of \$6,000,000, the estate's income tax basis would be \$45,600,000 (\$6,000,000 + \$39,600,000) and the §743(b) special basis adjustment would be \$42,000,000. So, the \$1,350,000 reduction in estate tax resulting from the \$3,000,000 valuation discount (45% × \$3,000,000 = \$1,350,000) must be compared to the \$3,000,000 additional income tax gain that may be eventually reported.

Alternative Solution #2. This alternative can be used if the real estate owner has other assets that can be contributed to the real estate partnership. Assume the following revised facts:

Hodge, "On the Death of Dr. Jekyll — The Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death," 29 *Tax Mgmt. Estates, Gifts and Trusts J.* 275, 283-284 (11/11/04). An unofficial administrative position taken by the IRS appears to support the position that there is no gain at death. See CCA 200923024 (6/5/09).

²¹ §1014(a).

PARTNERSHIP BALANCE SHEET

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>	<u>Value</u>
Real estate	\$4,000,000	\$54,000,000	Mortgage ²²	\$45,000,000
			<u>Capital</u>	
			Senior	\$9,000,000
				<u><u>\$54,000,000</u></u>

²² The amount of the mortgage for this example was increased to \$45,000,000 so that the example can use even numbers.

As part of the recapitalization of the partnership into preferred and common partnership interests, Senior will make an additional capital contribution. Assume that Senior contributes \$1,000,000 of cash²³ for

a common partnership interest and that the existing

cash and can be an appreciated or a loss asset because the basis in the contributed asset is not needed. All that is necessary is that the contributed asset is valued at \$1,000,000 for capital account purposes. See Regs. §1.704-3.

²³ The additional capital contribution can be an asset other than

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\$9,000,000 of capital is converted to a preferred interest with a priority return. Because all of the built-in gain, including all \$41,000,000 of the phantom gain (affectionately known by partnership types as “minimum §704(c) gain”), must be allocated to Senior’s preferred interest, Senior’s retention of the preferred interest as an asset in the gross estate upon Senior’s

Partner	Tax Basis	Gross Value
Preferred (90%)	\$4,000,000	\$54,000,000
Common (10%)	\$1,000,000	\$1,000,000

Now, Senior can dispose of the common interest, either by gift to a any trust or by a deferred payment sale to a grantor trust. Because none of the liabilities are allocated to the common interest, the common interest can be gifted to an individual or to a non-grantor trust without creating a part-sale/part-gift income tax gain event. With regard to the elimination of the phantom gain at death, it does not matter if the retained preferred interest at death is discounted. If the preferred interest is valued at \$9,000,000, the §743(b) special basis adjustment is \$50,000,000. If the preferred interest is discounted and valued at \$6,000,000, the §743(b) special basis adjustment is \$47,000,000. Thus, the entire \$41,000,000 of phantom gain is eliminated at death regardless of the value of the preferred interest in the gross estate at death.

Alternatively, the \$1,000,000 capital contribution in exchange for a common limited partnership interest can be made by someone other than Senior, such as a child.

Query? Can the value of the capital account for the preferred partnership interest be discounted for lack of control if Senior contributes a limited partnership interest in an existing family limited partnership that already owns the real estate to a newly formed family limited partnership in exchange for a preferred interest in the new family limited partnership, using the discounted value of the existing family limited partnership interest as the capital contribution to the new family limited partnership? If the new family limited partnership was created principally for the purpose of creating discounts, the Regulations promulgated under §2701²⁵ provide that for capital account purposes, the voting rights of all family members will be aggregated for purposes of determining the value of a non-voting interest. Interestingly, this regulation was

²⁵ Regs. §25.2701-3(b)(1)(i) provides that “The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions.”

death eliminates all of the \$50,000,000 of built-in gain.²⁴ The key planning aspect here is that under the partnership liability allocation Regulations, none of the existing \$45,000,000 of liabilities can be allocated to the common interest.

²⁴ Regs. §1.704-3(a)(1).

Liability	Phantom Gain	Capital Account
\$45,000,000	\$41,000,000	\$9,000,000
None	None	\$1,000,000

adopted before the IRS conceded this aggregation approach in Rev. Rul. 93-12.²⁶ Therefore, there is considerable doubt that this regulation’s requirement that all family-held interests must be aggregated continues to apply. If the limited partnership interest is in an existing commercial partnership that owns the encumbered real estate, it appears that a lack of control discount will be permitted for commercial limited partnership interests.²⁷

CONCLUSION

As discussed in the article, the income tax sophistication required to properly design and effectuate a preferred freeze partnership is set forth in the Code and the regulations. None of the commonly used freeze techniques, such as a gift, the GRAT and the installment sale to a grantor trust, offer the income tax advantage offered by the preferred partnership freeze. Only with the preferred partnership freeze will there be certainty as to the ability to obtain a basis step-up upon death for low basis leveraged assets which have liabilities in excess of basis. Unfortunately, the preferred partnership freeze technique is often overlooked because it presents significant complexities. And, as the return that must be paid on the preferred partnership interest cannot be tied to the AFR, the economics of the freeze partnership can be a challenge to the planner. However, by employing the ideas and techniques set forth in this article, these challenges can be overcome.

²⁶ In *Bright Est. v. U.S.*, 658 F.2d 999 (5th Cir. 1981), the court rejected this aggregation approach for interests owned by family members. The IRS finally accepted the holding in *Bright Est.* in Rev. Rul. 93-12, 1993-1 C.B. 202.

²⁷ PLR 9639054 (9/27/96) indicates that there is no look-through if the partnership owning the real estate is not a family entity.