Crain’s Cleveland Business: Learn from our past mistakes to avoid the next real estate bubble

Stephen M. Breitstone and Richard Brown of Integrity Group co-authored this opinion piece which was published on June 6, 2017.

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Bloomberg BNA Tax Management Real Estate Journal: Something New in the Toolbox: The Installment Sale-Reacquisition Approach to Real Estate Development Projects

In a fairly common fact pattern in the recent upward-trending real estate market, a taxpayer owns land or air rights that it wishes to develop into an income-producing asset. The taxpayer and a developer agree that the developer will acquire a portion of the taxpayer’s land or air rights provided that the taxpayer winds up owning an income-producing real estate asset on the property that it retains. In effect, the developer will construct improvements for the taxpayer in exchange for part of the taxpayer’s property.

Roth IRAs and Real Estate Investments

By Richard Reichler

The “Roth IRA” is a form of long-term, tax-free investment that may be well-suited to those who believe that real estate assets are now priced for future appreciation.

The tax consequences of Roth IRAs are different from those of regular IRAs. Contributions to a Roth IRA are not tax deductible, but all of the "qualifying distributions" received from Roth IRA are free of tax. Thus, at the cost of not obtaining a deduction for the money placed into a Roth IRA, appreciation of the assets will escape any tax until distributed. Moreover, the tax rules permit much more time to elapse before requiring a distribution from a Roth IRA than is allowed for either an accumulation in a tax-qualified plan, such as a 401(k) plan, or a regular IRA. The required minimum distribution rules do not apply to a Roth IRA during the owner's lifetime. If the surviving spouse treats a Roth IRA of the deceased spouse as his or her own, there are no required minimum distributions during the spouses's lifetime…

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Popular Estate Planning Techniques Can Cause Income Tax Horrors For Real Estate Owners

By Stephen M. Breitstone

The real estate wealth created over a lifetime (or over generations) can be lost absent tax and succession planning. For the large real estate portfolio, liquidity is usually a major concern. Therefore, it is essential to plan early and often to preserve the wealth for future generations. In the haste to do proper planning for estate taxes, estate planners often tout the popular estate planning techniques de jour in the hope of saving estate taxes that can amount to 55% or more of the decedent's estate (even in light of current repeal legislation).

However, income tax considerations particular to real estate are often overlooked. There is a long history of tax laws that encouraged real estate owners to finance growth by refinancings, and that allowed real estate owners to claim tax depreciation and losses. The problem is that these tax benefits must be "recaptured" unless the property is held until death at which time a stepped up basis is allowed – at least until 2010, when the estate tax repeal is scheduled to go into effect.(2)

An otherwise sound estate plan can reek havoc when it is devoid of proper income tax planning. Absent proper attention to income taxation, gifts can trigger income tax gain to the transferor sooner or later. Or perhaps worse, the intended recipients can be saddled with an income tax liability – which can in some cases exceed the value of the gift!

This Article discusses the income tax pitfalls that can result from the use of popular estate planning techniques. It also describes a technique that can be used to avoid those pitfalls. This technique is known as the "preferred partnership freeze."

The Current Estate Planning Environment

Shortly after the purported repeal of the Federal Estate Tax under The Economic Growth and Tax Relief Reconciliation Act of 2001, the community of estate planning experts and pundits concluded that, at least for the wealthy, estate planning should continue as before or be expanded. This is because the tax legislation leaves open the major question of whether the repeal will ever really go into effect. Although the repeal is scheduled to go into effect at the beginning of 2010, and then to be reinstated in 2011, it is likely that budgetary constraints will require Congress to revisit the entire package long before that time. In the meantime, there is an Estate Tax to contend with for at least the next nine years. Further, when planning for the larger estate, it is dangerous to assume that repeal will go into effect, and if it does, that it will be permanent. Years of advance planning are necessary to contend with the enormous liquidity problems facing the estates of most real estate entrepreneurs. Accordingly, most planning for the very wealthy will continue substantially as before.

Popular Techniques that can Trigger Income Tax Horrors

Tax and estate planning for real estate presents it own challenges due to the heightened importance of income tax consequences. Popular estate planning techniques such as grantor retained annuity trusts ("GRATs,"), installment sales to defective grantor trusts ("IDITS") and outright gifts may not work well for real estate since they can trigger unexpected gain and income taxes. This can occur with leveraged real estate if there are "negative capital accounts" on interests in partnerships and limited liability companies or, for real estate owned outright, where liabilities are greater than the income tax basis. This scenario is relatively common for real estate interests where cash proceeds of refinancings have been taken or where the property has been fully depreciated. Worse yet, the triggering of this gain can often result in an income tax liability to the transferor that is greater than the potential estate tax savings that were the initial motivation for the creation of the GRATs, IDITS, etc.

Both GRATS and IDITS are, if correctly drafted, known as "Grantor Trusts" within the meaning of section 671 of the Code. The consequences of being a grantor trust is that income earned by the GRAT or IDIT is deemed to be earned by the grantor, and thus taxed to the grantor.(3 In addition, a transfer to a GRAT or IDIT is essentially ignored for income tax purposes.(4) These characteristics generally enhance the tax benefits and estate planning objectives of the grantor. For example, in general, a sale, even of leveraged real estate, to a GRAT or IDIT will not trigger a taxable gain to the grantor. Similarly, a gift of property subject to liabilities in excess of basis (or a partnership interest with a negative capital account) to a GRAT or IDIT will not be a taxable event to the grantor. Contrast this with an outright gift of such property that will, at a minimum, be treated as a taxable sale of the gifted property for the amount of the liabilities.

The problem with this nonrecognition of gain tax treatment is that the taxable event that was avoided when the GRAT or IDIT was created may be triggered later upon the termination of the grantor trust status of the trust. In the case of a GRAT, this occurs upon the expiration of the term of the GRAT. For an IDIT, termination will occur upon the death of the grantor or perhaps sooner.

The GRAT or IDIT transactions also forego a stepped up basis upon death which can extinguish the phantom income tax liability potential inherent in such leveraged real estate interests forever. Although all gifting foregoes a stepped up basis, and that can be a reasonable tradeoff to save estate taxes, in the context of leveraged real estate with liabilities in excess of basis, the loss of a stepped up basis can be fatal to an otherwise sensible plan.

As described below, a technique that can provide the best of both worlds is the Preferred Partnership Freeze. This technique can be used to transfer values out of the estate without foregoing the basis step up which is necessary to eliminate the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (in the case of real estate owned by a partnership or limited liability company).

Illustration of the Problem ,br> Under current law, estate tax rates (up to 50%) are higher than income tax rates with the phase out of the credit for state taxes scheduled to go into effect beginning in 2002. Capital gains can be taxed at a rate as low as 20% (25% for depreciation recapture). A popular misconception is that since income tax rates are lower than estate tax rates, triggering built in gain through the use of GRATS, IDITS and outright gifts is a reasonable tradeoff. However, with leveraged real estate, the amount subject to income tax may be many times greater than the amounts subject to estate tax. This is because the estate tax is imposed on the “equity value” of property in the estate. The income tax, on the other hand, is imposed on the total negative capital account or liabilities in excess of basis – either of which could be much greater in the extreme case.

This point can be illustrated as follows: Assume a parcel of real property has a fair market value of $1,000,000 and is subject to a mortgage of $800,000. Thus, the equity is worth $200,000. Also assume the property has a cost basis of $50,000. If the property were sold, the gain subject to income tax would be $950,000 resulting in income tax of approximately $237,000 assuming a combined state and Federal tax rate of 25%. Under that scenario, the tax would be $37,500 greater than the equity. To dispose of that property, the owner would have to come “out of pocket” to pay the taxes. If it were possible to transfer that property to heirs, absent a basis step up, you would be transferring a net liability after taking into account income taxes. Contrast this with the estate tax liability (assuming a 50% rate). The estate tax would be $100,000, $137,000 less than the income tax liability inherent in the asset.

Since a basis step up is foregone when property is gifted, sooner or later the recipient of the property will have to pay that built in income tax liability. To forego the basis stepup as in the case of an outright gift, a GRAT or an IDIT, will, in effect, foist a net liability upon the intended beneficiaries.

As discussed above, the problem is that recapture gain can be triggered when the GRAT or IDIT ceases to be a grantor trust. This occurs upon the termination of the GRAT assuming the grantor survives the term. If mortgaged property exists in the trust upon its termination, the IRS will treat the termination as a sale for the amount of the unpaid balance of the mortgage debt.(5) When this debt exceeds the adjusted tax basis of the property, gain is required to be recognized by the grantor.

The income tax results are less clear when an IDIT that owns leverage property ceases to be a grantor trust (i.e., as a result of the grantor’s death). The IRS is likely to take the position that the death of the grantor will trigger a deemed sale for the mortgage or other debt of the trust. (6) If the Service is successful, this can result in gain recognition whenever liabilities exceed basis. It is not clear that the courts would sustain the Service’s position.

Some commentators agree with the IRS’s view taking the position that the cessation of grantor trust status triggers a deemed sale immediately before death.(7) Since the deemed sale occurs pre-death, the stepped up basis is not available to eliminate the gain. Other commentators take the position that the immediately-before-death position is not supportable because the death of the grantor is the cessation event and the deemed transfer from the grantor to the trust therefore cannot take place immediately before death.(8) As a result, the deemed transferor of the property must be the grantor’s estate and there is no gain recognized because there will be a stepped-up basis.

There is little reason to assume this risk when an alternative technique is available that can achieve substantially the same economic objectives. That technique is the Freeze Partnership.

The Freeze Partnership

Like, GRATS, IDITS and outright gifts, the freeze partnership permits future appreciation to accumulate outside of the estate.(9) This effect is often referred to as the “estate freeze.” However, unlike the other techniques, the freeze partnership does not sacrifice the stepped up basis needed to eliminate the inherent tax liability attributable to negative capital accounts or liabilities in excess of income tax basis. Furthermore, this technique is expressly allowed under Federal tax law.(10)

Briefly stated, the freeze partnership typically has two classes of partnership interests. There is a preferred interest, entitled to a preferred return and a liquidation preference (like preferred stock), and a junior equity interest, which is entitled to growth and appreciation (like common stock). The preferred interest is typically retained and the junior equity interest must be worth at least 10% of the value of the partnership at the time of the transfer. The transaction is called a freeze partnership because the value of the preferred interest is frozen at the time the junior interest is transferred and only the junior equity interest appreciates in value over time as the partnership assets appreciate in value. A transfer of noncontrolling, nonmarketable minority interests to the freeze partnership may enhance this technique even further since assets will be contributed to the partnership at discounted values.

Partnership freezes are generally governed by IRC section 2701 and the accompanying regulations. Section 2701 applies where the junior equity interest is transferred to a member of the transferor’s family. Family members include the transferor’s spouse, lineal descendants of the transferor or his spouse and the spouse of any such descendant.(11) In this situation, unless the provisions of section 2701 are followed, the preferred interest is value at zero, thereby inflating the value of the transferred junior equity interest to an amount equal to the entire value of the partnership. This treatment acts as a penalty by artificially inflating the amounts subject to gift taxation.

In order to prevent this result, section 2701 requires that the retained interest be “an applicable retained interest.” An applicable retained interest is an interest that requires, inter alia, mandatory distributions that are cumulative to be paid in respect of the retained preferred interest.

If the requirements of section 2701 are satisfied, the retained preferred interest will not be valued at zero. Rather, the fair market value of the retained preferred interest would be deducted from the fair market value of the capital of the partnership, with the difference being the gift tax value of the junior equity interest. The value of the junior equity interest, so determined, less any consideration paid for that interest, will be a taxable gift. Note that section 2701 deems the junior equity interest to have a value of not less than 10% of the total value of the partnership.

Non-Tax Benefits of the Partnership Freeze

In addition to the tax reasons for considering the partnership freeze, there are numerous non-tax reasons for using the partnership freeze. For example, the creator can retain an interest in the income of the venture for life and like all family partnerships, the creator can retain control, or provide for an orderly transition of control to later generations. In addition, it is easier to manage the real estate portfolio as a whole through a single partnership (that acts like a holding company), rather than being forced to manage the portfolio on a property-by-property basis. The partnership structure also works far better than a management company structure that can be more easily dismantled by competing or conflicting heirs.

A Note of Caution

The freeze partnership technique can be more complex to implement than typical estate planning techniques. It requires not only estate planning expertise, but also an intimate understanding of the workings of the partnership income tax rules that have become one of the most complex areas of the Internal Revenue Code.

IRS Expands Tax-Free Exchanges of Real Estate

By Stephen M. Breitstone

In our practice and in the real world, it is usually easier to purchase real estate than to sell real estate. This often presents real world difficulties for businesses seeking to take advantage of the "like-kind" exchange provisions under section 1031 of the Internal Revenue Code. Typically, a corporation will identify a site suitable for its expanding business operations before it will commence efforts to sell the headquarters or manufacturing facility it has outgrown. However, because the new site often requires modifications to suit the expanding business or is to be built from the ground up, it is usually impractical to even consider selling an existing site until the new site is up and running. Until the recent issuance of Revenue Procedure 2000-37, 2000-40 IRB xxx, one of the huge tax issues facing an expanding business in this situation was whether it was possible to purchase the new site prior to relinquishing ownership of the old site and still receive tax-free "like-kind" exchange treatment under Section 1031.

"Like-kind" exchanges under Section 1031 of the Internal Revenue Code provide one of the most viable methods of disposing of real estate without paying income tax on accrued gains. However, it is often difficult to arrange a straightforward exchange under Section 1031 in the real world because of the difficulty, if not impossibility, of matching two parties who are both seeking an exchange of real estate and who own real property which is suitable for the other party's needs. Fortunately, the statute, regulations and case law have evolved to permit a wide variety of arrangements that are designed to allow tax-free, "like-kind" exchange treatment to be obtained through the use of various types of accommodation party arrangements. For example, pursuant to the statute and regulations, a so-called "qualified intermediary" may be used to effectuate an exchange, provided that both the identity of the property to be acquired in the exchange and the actual exchange meet certain time restrictions. However, notwithstanding this considerable latitude and certainty the IRS has not, until the recent publication of Revenue Procedure 2000-37, 2000-40 IRB xxx, condoned the so-called "reverse exchange."

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However, notwithstanding this considerable latitude and certainty the IRS has not, until the recent publication of Revenue Procedure 2000-37, 2000-40 IRB xxx, condoned the so-called "reverse exchange."

In order to bring this type of transaction within the parameters of Section 1031, taxpayers have arranged for an accommodation party to acquire the replacement property and hold it until the point in time when the relinquished property is ready to be transferred. When this occurs, the transfer is documented as an exchange with the accommodation party of the replacement property for the relinquished property followed by a resale of the relinquished property to a third party.

Until the recent publication of Rev. Proc. 2000-37, there were always concerns that the IRS would not treat this type of transaction as a like-kind exchange under section 1031, especially when the accommodation party could be viewed as a de facto agent of the transferor. With the publication of Rev. Proc. 2000-37, taxpayers can be assured that, by following certain safe harbors provided within Rev. Proc. 2000-37, such transactions will be treated as a section 1031 exchange.

In addition to these safe harbors, taxpayers must continue to follow certain technical requirements and fairly limited time frames relating to all section 1031 exchanges. It is not clear whether transactions falling outside these requirements will still qualify for Section 1031 exchange treatment. However, the Rev. Proc. 2000-37 does not necessarily infer that they would not.

The safe harbor requirements of Rev. Proc. 2000-37 are briefly summarized as follows:

1) Qualified indicia of ownership (i.e., legal title) must be held by a person who is not the taxpayer or a disqualified person (i.e., taxpayer's agent) and either such person is subject to federal income tax, or if such person is a partnership or S corporation, more than 90% of its interests or stock are owned by partners or shareholders who are subject to federal income tax.

2) At the time the qualified indicia of ownership of the property is transferred to the accommodation party, it is the taxpayer's intent that the property represents either replacement or relinquished property.

3) No later than five days after the transfer to the accommodation party, the taxpayer and the accommodation party enter into a written agreement providing that the accommodation party is holding the property in order to facilitate a Section 1031 exchange under this revenue procedure and that the taxpayer and accommodation party agree to report the entire transaction as provided in the revenue procedure.

4) The relinquished property is identified within 45 days after the transfer of the replacement property to the accommodation party.

5) Within 180 days after the transfer to the accommodation party, the property is transferred to the taxpayer as replacement property, or the property is transferred to a person who is not the taxpayer or disqualified person as relinquished property.

6) The combined time period that the relinquished property and the replacement property are held by the accommodation party not exceeding 180 days.

With the publication of Rev. Proc. 2000-37, the IRS has provided taxpayers with a suitable means of qualifying their transactions under Section 1031 where the taxpayer has a genuine intent to accomplish a "like-kind" exchange at the time the taxpayer arranges for the acquisition of replacement property and actually accomplishes the exchange within a short time thereafter