


By **Scott M. Sambur** & **Nordin M. Farez**

# Maximizing Tax Benefits With Real Estate Partnerships

A solution using freeze structures

Real estate partnerships are difficult assets for estate planning. Many of these partnerships previously took advantage of low interest rates and appreciation in the value of their properties to refinance mortgages and extract cash. The debt placed on the properties is often nonrecourse; thus, distributions of the extracted cash by the partnership to the partners cause an allocation of a share of the partnership's nonrecourse indebtedness to the distributee partner.[1] This allocation severely limits opportunities for estate planning because when the partner attempts to gift or sell his partnership interest, the relief from his share of the partnership's nonrecourse indebtedness generates gain that must be recognized to the extent that such share exceeds the partner's basis in the property (which, due to allocated depreciation deductions and the distribution of debt-financed proceeds to the partner, is often zero).[2]

## Gifting Issues

As a result, outright gifting by the first generation (G1) to the second generation (G2) or to a non-grantor trust for the benefit of G2 and more remote descendants can be painfully expensive, as the gift results in the recognition of gain from the relief of the donor's share of partnership nonrecourse indebtedness, which in some cases could equal or exceed the fair market value of the partnership interest. Furthermore, the donee would receive a partnership interest with a low or zero basis,[3] resulting potentially in additional gain recognition on the donee's eventual disposition of the interest.

If the donor were instead to gift the partnership interest to a grantor trust, there would be no recognition of capital gain at the time of the gift, but the negative tax attributes of the transferred partnership interest would remain with the donor.[4] At the donor's death, the law is unsettled as to whether the trust's basis in the gifted interest would be stepped-up to date-of-death value and whether the donor's estate could avoid gain recognition as a result of being relieved of its share of partnership nonrecourse indebtedness with respect to the gifted interest. But, some commentators think the answer to both questions is "no."[5]

## Interest Expense

Another problem that often plagues real estate partnerships is the treatment of the partnership's interest expense. If a partner receives a distribution of the proceeds of nonrecourse indebtedness, his share of the partnership's interest expense is characterized by reference to the use to which he put the distributed proceeds.[6] If the partner invests the proceeds in additional real estate projects, the interest expense would be characterized as passive (assuming the partner isn't primarily engaged in the real estate business) and could be used to offset income from the partnership.[7] If instead, the partner invested the proceeds in a portfolio of stocks and bonds, his share of the partnership interest expense would be treated as an investment interest expense and could only be deducted against investment income.[8] If the partner used the proceeds to buy non-investment tangible personal property or for general spending, the partner would be out of luck—his share of the partnership interest expense would be non-deductible.[9]

For example, if a partner received a distribution of the proceeds from a nonrecourse loan and used those proceeds to purchase a boat, he wouldn't be

**Scott M. Sambur**, far left, is a partner at Seward & Kissel LLP in New York City and **Nordin M. Farez** is a manager in the Mergers & Acquisitions tax practice at PricewaterhouseCoopers LLP in San Francisco


able to deduct any of his share of the partnership's interest expense related to servicing that loan. As a result, in a future year, if the partner's share of partnership profits (net of interest expense) were $2 million and his share of the partnership's interest expense were $1.5 million, the partner would be taxed on $3.5 million of income. This "phantom income" would raise his effective federal income tax rate at the margin to approximately 76 percent, with the partner owing $1.519 million of income tax on $2 million of profits!

## The Freeze Partnership Transaction

A potential solution to this problem is to combine a non-grantor trust, a cash gift and a freeze partnership. The resulting structure would allow the shifting of a substantial portion of the appreciation in a real estate partnership to G2, while providing for a step-up in basis at G1's death to the value of G1's interest in the freeze partnership, while further providing for substantially increased post-income tax cash flow to G1. Here's how the transaction would be structured:

1. G1 would establish a non-grantor trust for the benefit of G2 and make a large cash gift to the trust.
2. G1 would form a limited liability company (LLC) and contribute to it his interests in the real estate partnership.
3. After a reasonable period of time had elapsed, the trust would contribute the gifted cash to the LLC.
4. The LLC operating agreement would provide a window of time for any member to convert his interest from a common interest (that is, an interest that would have a right to participate in the growth of the LLC) into a preferred interest, with a par value equal to the capital account of the converted common interest and carrying a guaranteed payment as defined in Internal Revenue Code Section 707(c). A guaranteed payment isn't considered an interest in partnership profits; as a result, under IRC Section 2701, only one class of interest would be present in the LLC, and the complicated rules of that section, which govern transfers to family members of interests in entities that have more than one class of interest, wouldn't come into play.[10]
5. G1 would exercise his conversion option to receive a preferred interest calculated such that the appraised value of the preferred interest would equal the value of G1's interest in the LLC reduced by $100,000 or so. It's necessary for G1 to own some amount of common interest in the LLC to be considered a member of the LLC.[11] Without this interest, it's likely that the conversion by G1 of his LLC interest to a preferred return could be considered a realization event as a result of G1 being relieved of his share of the underlying partnership's nonrecourse indebtedness when he ceased to be a member of the LLC.

> A guaranteed payment isn't considered a partnership interest for purposes of sharing in the partnership's profits and losses.

If, for example, the real estate partnership interests contributed by G1 to the LLC were worth $25 million and the trust had contributed $5 million, the combined value of the LLC would be $30 million, with G1 owning a preferred return of $24.9 million and a common interest in the LLC of $100,000, while the trust would own a common interest worth $5 million.

## Economic and Tax Effects

By using this structure, all of the subsequent appreciation in the LLC would inure to the trust (other than the small amount of appreciation inuring to G1 as a result of the retained common interest—in the above example, this amount would comprise less than




2 percent of future appreciation). Each year, the LLC would be required to make a guaranteed payment to G1 in respect of the preferred interest. While the actual percentage payout would be determined by appraisal and depend on a number of factors, including the cash flow and distribution policy of the underlying partnership, the likely range for a real estate partnership with steady cash flow and low vacancy rates would be between 6.5 percent and 8.5 percent of the value of the converted interest at the time of conversion.

Assuming a 6.75 percent preferred rate, the guaranteed payment in the above example would be $1,680,750

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per year. Unlike the cumulative dividend used in more typical freeze partnerships, which can be deferred for up to four years if the LLC has insufficient cash flow,[12] the guaranteed payment must be made each year. However, the cash contributed by the non-grantor trust would provide a small buffer, allowing for a few years of payment if the cash flow from the underlying real estate partnership were to decrease.

As noted above, a guaranteed payment isn't considered a partnership interest for purposes of sharing in the partnership's profits and losses. Accordingly, the entire amount of the $1,680,750 guaranteed payment would be ordinary income to G1. Assuming the real estate partnership generated and distributed $2 million of net profits each year, the remaining $319,250 would be allocated to the members in accordance with their proportionate share of the total common interests (that is, $6,260 to G1 and $312,990 to the trust). Further, the cash contributed to the LLC could be invested and would (hopefully) generate a return, with any profits allocated as just described.

In addition to allowing most of the future profits and appreciation in the LLC to inure to the non-grantor trust, this transaction would also have beneficial income tax results for the members. Generally, for federal income tax purposes, deductions can be allocated among the partners in any way desired, so long as the allocation has substantial economic effect.[13] Here, the interest expense deduction would be allocated among the members in proportion to their respective common interests (because the guaranteed payment isn't an LLC interest entitled to share in profits and losses of the LLC). Thus, under the above example, the interest expense would be allocated $29,412 to G1 and $1,470,588 to the trust.

G1 would remain unable to deduct his allocated interest expense, but the trust should be able to deduct all of the interest expense allocated to it. The only authority on this subject is Notice 89-35 (the Notice), which provides in part:

> [D]ebt of passthrough entities and the associated interest expense shall be allocated under the rules of [Treas. Reg. S]ection 1.163-8T. In general, when debt proceeds of a passthrough entity are allocated under [Treas. Reg. S]ection 1.163-8T to distributions to owners of the entity, the debt proceeds distributed to any owner and the associated interest expense shall be allocated under [Treas. Reg. S]ection 1.163-8T in accordance with such owner's use of such debt proceeds. For example, if the owner uses distributed debt proceeds to purchase an interest in a passive activity, the owner's share of the interest expense on such debt proceeds is allocated to a passive activity expenditure (within the meaning of [Treas. Reg. S]ection 1.163-8T(b)(4)).

An owner's share of a pass-through entity's interest expense on debt proceeds allocated to distributions to owners may exceed the entity's interest expense on the portion of the debt proceeds distributed to that particular owner. In such cases, the entity shall allocate the owner's excess interest expense using any reasonable method. The determination of whether a particular method of allocating such excess interest expense is reasonable depends on the facts and circumstances including, without limitation, whether the entity consistently applies the method from year to year.

Turning to the above example, the first paragraph


of the Notice relates to the characterization of the interest expense allocated to G1. Because G1 used the loan proceeds for personal use, G1 wouldn't be able to deduct the interest expense allocated to him. However, no loan proceeds were distributed to the trust. Pursuant to the second paragraph, the characterization of the interest expense allocated to the trust should be based on any reasonable method, taking into account the relevant facts and circumstances.

Given that the trust contributed new capital to the LLC and didn't receive its interest in the LLC as a gift, and the real estate partnership's interest expense would, in the absence of the prior distribution of loan proceeds to G1, be entirely deductible to the partners against the income from the real estate partnership, it appears reasonable for the trust to be able to deduct in full the interest expense flowing through from the real estate partnership against the income flowing through from the partnership, by treating the interest expense as a passive activity expense. There doesn't seem to be any authority on this subject, either in support of or against this position, other than the Notice. Nevertheless, it appears that the Notice provides sufficient support based on its plain language to take this position.

Prior to the transaction, G1 would have paid income tax of $1.519 million on $2 million of profit (and distribution), due to the non-deductible $1.5 million of interest expense allocated to him, and would have only $481,000 after tax. Under the above-described structure, G1 would receive a guaranteed payment of $1,680,750 and a distribution of net profits with respect to the common interest in the LLC of $6,260. G1 would pay tax of $729,446 on the guaranteed payment and tax of $15,482 on the distributed profits (due to the non-deductible $29,412 of interest expense allocated to him), and would have received $942,083 after tax, an increase to G1 of $461,082 of after-tax income each year!

The remaining $312,990 of LLC net profits and $1,470,588 of interest expense would be allocated to the trust. The interest expense should be fully deductible against the income flowing through from the real estate partnership, and the trust should therefore not pay any income tax (except on its share of the income, if any, from the invested cash). As a result of this transaction, not only would G1's after-tax income have increased substantially, but also substantial additional income would be able to flow tax-free to the trust and, eventually, to G2 and more remote descendants of G1. Overall, an additional $774,773 would be available to the LLC members after tax as compared to before the transaction.

This transaction will generally work for any real estate partnership that generates a steady flow of profits. However, if the partnership's real estate assets don't produce a steady flow of profits, it's possible that the appraised preferred return might require a percentage payout that's too high to be sustainable. In such a situation, the transaction is often still feasible, but would require the conversion of less of G1's LLC common interest and would, therefore, shift less appreciation to the trust. Nevertheless, for a real estate partnership with steady profits, this transaction can be a highly effective means of transferring wealth to younger generations, while simultaneously increasing the after-tax income flowing to G1 and the trust.

## Endnotes

1. *See* Treasury Regulations Sections 1.752-3 and 1.704-2(g).
2. *See* Internal Revenue Code Sections 731(a)(1) and 752(b).
3. *See* IRC Section 1015(a).
4. Because a grantor trust is disregarded for U.S. federal income tax purposes, the donor's gift of the partnership interest to the grantor doesn't relieve the donor of any share of partnership nonrecourse indebtedness. By the same token, the gift doesn't change the donor's income tax position in respect of the gifted partnership interest.
5. *Compare* Carol A. Cantrell, "Gain is Realized at Death," *Trusts & Estates* (February 2010), at p. 20, *with* Jonathan G. Blattmachr and Mitchell M. Gans, "No Gain at Death," *Trusts & Estates* (February 2010), at p. 34.
6. Notice 89-35, 1989-1 C.B. 675.
7. *See* IRC Section 469(c)(7).
8. *See* IRC Section 163(d).
9. *See* IRC Section 163(h)(1).
10. IRC Section 2701(c)(1)(B)(iii); Treas. Regs. Section 25.2701-2(b)(4) ("[m]andatory payment rights, liquidation participation rights, rights to guaranteed payments of a fixed amount under [S]ection 707(c), and non-lapsing conversion rights are neither extraordinary payment rights nor distribution rights").
11. *See Historic Boardwalk Hall, LLC v. Commissioner,* 694 F.3d 425 (3rd Cir. 2012).
12. IRC Section 2701(d)(2)(C), (3)(A)(iii).
13. *See* IRC Section 704(b). Nonrecourse deductions, however, must be allocated in a manner that's reasonably consistent with the allocation of some other significant partnership item attributable to the property securing the debt. Treas. Regs. Section 1.704-2(e)(2).