# INCREASING THE INCOME TAX AND ESTATE TAX BENEFITS FOR THE PREFERRED PARTNERSHIP WITH ENCUMBERED REAL ESTATE WITH FUTURE LEVERAGING


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# WHAT CAN THE PREFERRED FREEZE PARTNERSHIP PROVIDE THAT GIFTS, GRATS AND INSTALLMENT SALES TO GRANTOR TRUSTS CANNOT PROVIDE?

- Gifts, GRATs, Installment Sales and Preferred Partnerships all shift a portion of a partnership's annual income to trusts ("*financial leverage*"). A GRAT is a deferred payment sale of an asset for a fixed annuity that pays principal and interest and amortizes the sale price over the GRAT term
- They all shift any appreciation in the value of assets to irrevocable trusts not exposed to the transfer taxes (the "*freeze*").
- They all can use grantor trusts so that the grantor pays the income taxes on all partnership income including what goes to the holder of the common interests (the "*burn*" *TM by Richard Oshins*).

# WHAT CAN THE PREFERRED FREEZE PARTNERSHIP PROVIDE THAT GIFTS, GRATS AND INSTALLMENT SALES TO GRANTOR TRUSTS CANNOT PROVIDE?

- Only the preferred partnership, by retention of the preferred interest, can use the tax-free *step-up in basis at death*.
- Only the preferred partnership can provide decedent with a *guaranteed payment for life*. GRATs and installment sales have fixed payment terms that end while the decedent is living.
- Only the preferred partnership interest can *qualify for § 6166* because it is included in the gross estate (15-year payout of estate tax).

# What is a Freeze Partnership?

- It is a partnership (or LLC taxed as a partnership) with two classes of ownership interests:
- The preferred interest – entitled to a fixed return on its capital account (a priority return) with a liquidation preference; and
- The common interest – entitled to everything else, including all future growth of income and all appreciation in the value of partnership assets. But, no liquidation preference.
- Liquidation preference: Cannot redeem the common partner's capital contribution until the preferred partner's capital contribution is fully redeemed. Does this only apply upon the termination of the partnership? Or does it also apply if the partnership continues? This not clear.

# Key Estate and Income Tax Objectives

1. To *obtain an income tax-free step-up in basis at death* when including encumbered real estate in the gross estate.
2. To reduce *the "leaky freeze*" by minimizing the hurdle rate paid on the retained preferred interest. This is accomplished by increasing the coverage provided by the common interest so that the preferred priority allocation percentage can be reduced. (see slides #23-24)
3. To *lock in valuation discounts* on the common interest and on the property contributed to the partnership. Dispose of the common interest by a gift or sale of the common interest to an irrevocable trust.

# Impact of §7520 and §1274 (the AFR)

- The preferred is not an interest in a trust
- The preferred is not a debt obligation
- As an equity interest in a partnership, the preferred must use market rates. See Rev. Rul. 83-120
- Market rates are typically higher than the 7520 rate (4.40% for March 2023) and the long-term AFR (3.74% for March 2023).
- An objective is to have a low preferred rate of return. (see slide # 24).

# THE COMMON INTEREST IS ALLOCATED ALL EXCESS INCOME AND ALL APPRECIATION IN VALUE

4. To *freeze the discounted value of the common interest* and *shift the income allocated to the common interest to a trust that is not exposed to the estate tax*. Typically this is accomplished by the sale of the common interest for a promissory note so that the income generated by the common interest in excess of the note payment is shifted to an irrevocable trust ("*Financial Leverage" and "Freeze").*

5. To *enable the grantor to pay income taxes on all partnership income,* including that earned by the trust holding the common interest (the "*Burn*"). Have the common interest owned by a grantor trust.

# Example of a Preferred Partnership

- Senior creates a partnership, contributing a business valued at $20,000,000 for a preferred interest with a $10,000,000 capital account and a common interest with a $10,000,000 capital account. The preferred interest provides for a 6% priority allocation of partnership profits. All requirements under § 2701 are satisfied.
- Assume the business has no liabilities.

*Ignore valuation discounts for the common limited partnership interest*

# Example of a Preferred Partnership

- All appreciation in value for the $20,000,000 of assets owned by the partnership is allocated to the common interest. And, all partnership income in excess of $600,000 is allocated to the common interest.
- Senior sells the common interest to an irrevocable grantor trust for a $10,000,000 promissory note at the 4.43% long-term AFR for December 2022. The trust is a grantor trust to take advantage of the "burn."
- Alternatively, Senior can transfer the common interest to the grantor trust by gift.

# WHAT PRIORITIES MUST THE PARTNERSHIP PROVIDE THE PREFERRED PARTNER?

1. The preferred partner must receive a priority allocation of partnership income. Here, the first $600,000 of income (6% x $10,000,000 capital account) must be allocated to the preferred partner. Only income in excess of the priority allocation can be allocated to the common partner.
2. If the partnership desires to redeem all of a partners' contributed capital, all distributions must first be made to the preferred partner.

# What priorities must the partnership provide the preferred partner?

3. If partnership profits for any year are less than the preferred priority allocation, the shortfall must accumulate in arrears and all arrearages must be satisfied before any profit allocations can be made to the common partner.
4. Unlike a bond, where the loan principal must be paid at maturity, the partnership is not required to redeem the preferred partner's capital contribution.
5. Generally, risk of loss is first born by the common partner. Generally, losses cannot be allocated to the preferred partner until the common partner's capital account is exhausted.

# Using the Preferred Partnership for Encumbered Real Estate

**Example:**

Senior purchased a commercial office building in 1984 for $20,000,000. Senior allocated $16,000,000 of the purchase price to the building and depreciated the building over 18 years using ACRS. Over the years, Senior was able to take substantial funds out of the building income tax-free by refinancing the mortgage.

The real estate can also have a low basis by using §1031 like-kind exchanges.

# Sale of Encumbered Asset for $54,000,000 During Senior's Life

Current Status of Real Estate:

| | |
|---|---|
| Gross Value | $54,000,000 |
| Adjusted basis | $ 4,000,000 |
| Mortgage | $44,000,000 (refinancings over the years) |
| Equity | $10,000,000 |

- **Phantom** gain from liabilities in excess of basis is $40,000,000.
- Total income tax gain is $50,000,000.
- With a 13.3% California rate and a 23.8 % federal rate, an effective 37.1% rate, the **income taxes** on the gain are **$18,550,000** and easily exceeds the $10,000,000 cash netted on a sale.

# Encumbered Asset is Subject to Estate Tax

If Senior died, including the asset in the decedent's gross estate eliminates the entire $50,000,000 gain, including the $40,000,000 phantom gain (excess of liabilities over adjusted tax basis).

- At a cost of **$4,000,000 in estate taxes** on $10,000,000 of equity, including the encumbered real estate in decedent's gross estate eliminates all **$18,550,000 of income taxes** on the $50,000,000 of gain. Therefore, the estate can sell the property for $54,000,000 with no income tax and net $10,000,000 of cash.
- The downside if Senior continues to hold the real estate until death is that all appreciation will be exposed to the estate tax.

# Asset Continues to be Held After Death

- Even if the property continues as a rental property, the step-up in basis at Senior's death creates $50,000,000 of basis. Estate's basis is now $54,000,000.
- The building can be depreciated over 39 years (or 27½ years if the building is residential rental property).
- If the building continues to be held after death, $40,00,000 of the $54,000,000 basis can be allocated to the building. $40,000,000 can be depreciated against ordinary income. At a combined California and Federal 50.1% ordinary income tax rate, **$20,040,000 of future income taxes** are eliminated as the building is deprecated**.**

# Current Balance Sheet

| Asset | Basis | Value | Liabilities | Value |
|---|---|---|---|---|
| Real Estate | $4,000,000 | $54,000,000 | Mortgage | $44,000,000 |
| | | | Capital<br>Senior | <br>$10,000,000<br><br>$54,000,000 |

# ALTERNATIVE #1: CREATE A PARTNERSHIP WITH PREFERRED AND COMMON INTERESTS (90%/10% ALLOCATION)

Senior reorganizes the real estate as a partnership with two ownership classes. Senior disposes of the common interest by gift or by sale to a grantor trust that is not exposed to the estate tax. Senior uses the minimum 90%/10% capital account allocation permitted under §2701.

| Partner | Tax Basis | Gross Value | Liability | Phantom Gain | Capital Account |
|---|---|---|---|---|---|
| Preferred | $3,600,000 | $48,600,000 | $39,600,000 | $36,000,000 | $9,000,000 (90%) |
| Common | $400,000 | $5,400,000 | $4,400,000 | $4,000,000 | $1,000,000 (10%) |
| Totals | $4,000,000 | $54,000,000 | $44,000,000 | $40,000,000 | $10,000,000 |

Caution: §2701 requires that at least 10% of the partnership capital must be allocated to the common interest. Most estate planners naively use a 90%/10% allocation of capital. Common has liabilities in excess of basis. **Warning: Do not gift common to a non-grantor trust**

# Why must an encumbered common interest only be transferred to a grantor trust?

- If the common interest is gifted to a non-grantor trust or to an individual, the transferee is taking the asset subject to the $4,400,000 liability. Therefore, the transferee purchased a portion of the common interest for $4,400,000 and received the remaining $1,000,000 by gift. Allocating the $400,000 basis to the sale portion, results in a $4,000,000 gain that the donor must report.
- The transferee now has a $4,400,000 basis in the common interest.
- Likewise, an installment sale of the common interest to a non-grantor trust for a $1,000,000 promissory note requires that the $4,000,000 phantom gain be immediately reported with only $1,000,000 of the gain deferred under the installment method.

# ALTERNATIVE #1 (CONTINUED)

- Senior dies with only the frozen preferred partnership interest included in Senior's gross estate.
- The liabilities remain the same. Senior's capital account is $9,000,000. The estate tax value for the preferred interest is $9,000,000. As the preferred is still allocated $39,600,000 of liabilities, the estate's income tax basis is $48,600,000.
- The transfer of the common interest, that was allocated $4,400,000 of the liabilities, retains the $400,000 of carryover basis because it was not in decedent's gross estate. Thus, $4,000,000 of phantom gain has not been eliminated.

# Current Financial Statement

| Asset | Basis | Value | Liabilities | Value |
|---|---|---|---|---|
| Real Estate | $4,000,000 | $54,000,000 | Mortgage | $44,000,000 |
| | | | Capital<br>Senior | $10,000,000<br><br>$54,000,000 |

# Alternative #2: Additional Contribution for Common Interest (50/50)

Senior contributes $10,000,000 worth of other assets with a $2,000,000 basis for a common interest and later transfers the common interest to a trust.* Senior's initial $10,000,000 capital account is converted to a preferred interest.

| Partner | Tax Basis | Gross Value | Liability | Phantom Gain | Capital Account |
|---|---|---|---|---|---|
| Preferred | $4,000,000 | $54,000,000 | $44,000,000 | $40,000,000 | $10,000,000 (50%) |
| Common (other assets) | $2,000,000 | $10,000,000 | None | None | $10,000,000 (50%) |

*Alternatively, Junior or an existing irrevocable trust can make the needed capital contribution for the common interest.

# Alternative #2: Additional Contribution for Common Interest

- At death the value for the real estate increased to $64,000,000. The entire $10,000,000 of appreciation is allocated to the common interest.
- At death, the preferred interest is included in the decedent's estate with the entire negative capital account allocated to the preferred interest. Therefore, the estate's basis for the preferred interest will be $54,000,000.
- The common interest, now valued at $20,000,000, is not exposed to the estate tax.
- Because the common interest is not in the estate, there is no step-up in basis at death for the $10,000,000 of value shifted to the common interest. *See slide # 33 to return that zero basis value to the decedent.*
- Caution. Should have a separate entity own a small common interest.

# THE LEAKY FREEZE

- A preferred 9% priority return needs to be used when only 10% of partnership capital is allocated to the common interest.

- Rev. Rul. 83-120 requires a market based approach for the priority return. A market based approach will provide a preferred return greater than the § 7520 rate used for GRATs or the AFR used for installment sales.

- Is it possible to reduce the preferred priority return?
  - The § 7520 rate is only used in valuing interests in trusts and annuity interests. A preferred interest is not an interest in a trust.
  - The AFR safe-harbor is only used for debt obligations. A preferred interest is equity – it is not a debt obligation.

- The use of the market based approach in Rev. Rul. 83-120 is appropriate.

# Reduce the Preferred Risk by Providing More Common Coverage

- Because the partnership allocated 50% of the capital to the preferred interest, the risks of under performance for the preferred is reduced because more capital is allocated to the common.
- With 50% of coverage by the common interest in Alternative 2, a market based approach will arrive at a preferred priority return in the 5% to 6% range. Hence, the leaky freeze has been minimized.
- *If the partnership owes money to Senior as an AFR loan, the §2701 regulations count the AFR loan as part of the preferred return*

# The Estate Tax Advantage by Selling the Common Interest to a Grantor Trust

- **The "Burn."** Even though the income earned by the grantor trust cannot be distributed to the grantor, the grantor is required to report the grantor trust's income on the grantor's individual income tax return. Therefore, the grantor must pay the income taxes on a grantor trust's income.
- **"Financial Leverage."** Sale of an asset generating a rate of return greater than the AFR interest rate on the promissory note
- **"Discounts"** Using a discounted value for the common limited partnership interest.

**Example:** Senior contributes $10,000,000 of *unencumbered* assets to a partnership for a $6,000,000 preferred limited partnership interest and a $4,000,000 common limited partnership interest. The preferred interest provides for a 6% priority return (6% x $6,000,000 = $360,000).

- A 25% valuation discount is used to value the common limited partnership interest at $3,000,000.
- Senior sells the common interest to a grantor trust for $3,000,000, taking back the grantor trust's promissory note at the long-term AFR (assume 2%), paying $60,000 interest annually with all note principal due in 20 years.
- Assume partnership income gradually increases each year.
- Assume Senior's income tax rate is 40%.

# Retain Preferred and Sell Common to Grantor Trust

- $10,000,000 capital contribution by Senior.
- $6,000,000 preferred – retained by Senior. 6% priority return ($360,000 distributed annually).
- $4,000,000 common – sold to grantor trust for $3,000,000 using a 2% interest-only note ($60,000 paid annually).
- Each year Senior receives only $420,000 ($360,000 + $60,000).
- Each year Senior pays the income taxes on all of the partnership's income.

# Retain Preferred and Sell Common to Grantor Trust

| Year | PS income | Preferred allocation | Common allocation | Note interest | Tax on preferred | "Burn" on common | Net to Senior | Net to grantor trust |
|---|---|---|---|---|---|---|---|---|
| 1 | $500,000 | $360,000 | $140,000 | $60,000 | $144,000 | $56,000 | $220,000 | $80,000 |
| 2 | $600,000 | $360,000 | $240,000 | $60,000 | $144,000 | $96,000 | $180,000 | $180,000 |
| 3 | $700,000 | $360,000 | $340,000 | $60,000 | $144,000 | $136,000 | $140,000 | $280,000 |
| 4 | $800,000 | $360,000 | $440,000 | $60,000 | $144,000 | $176,000 | $100,000 | $380,000 |
| 5 | $900,000 | $360,000 | $540,000 | $60,000 | $144,000 | $216,000 | $60,000 | $480,000 |
| 6 | $1,000,000 | $360,000 | $640,000 | $60,000 | $144,000 | $256,000 | $20,000 | $580,000 |
| 7 | $1,100,000 | $360,000 | $740,000 | $60,000 | $144,000 | $296,000 | <$20,000> | $680,000 |
| 8 | $1,200,000 | $360,000 | $840,000 | $60,000 | $144,000 | $336,000 | <$60,000> | $780,000 |
| 9 | $1,300,000 | $360,000 | $940,000 | $60,000 | $144,000 | $376,000 | <$100,000> | $880,000 |

# Factors to Consider After Formation of Preferred Partnership

- Real estate partnerships continue to refinance its property.
- The increase in partnership liabilities can increase the phantom gain in the preferred interest (liabilities in excess of adjusted basis) *i.e.* future increases in the phantom gain can be allocated to the preferred partner's negative capital account.
- **Example**: Preferred basis is $4,000,000. Common basis is $10,000,000.

| Partner | Tax Basis | Gross Value | Liability | Phantom Gain | Capital Account |
|---|---|---|---|---|---|
| Preferred (50%) | $4,000,000 | $54,000,000 | $44,000,000 | $40,000,000 | $10,000,000 |
| Common (50%) | $10,000,000 | $10,000,000 | None | None | $10,000,000 |

- The value of the partnership's real estate increases by $10,000,000. The $44,000,000 mortgage is refinanced for $50,000,000, netting the partnership an extra $6,000,000 of cash.
- The partnership distributes the additional $6,000,000 of cash to the preferred partner, reducing the preferred capital account from $10,000,000 to $4,000,000. The 6% priority allocation is no longer 6% x $10,000,000 = $600,000, but is now 6% x $4,000,000 = $240,000.
- Under the §752 regulations, the entire $6,000,000 increase in partnership liabilities is allocated to the preferred interest, increasing the preferred outside basis from $4,000,000 to $10,000,000. Upon a distribution of the $6,000,000 cash to the preferred partner, outside basis is reduced by $6,000,000 to $4,000,000.
- ***Caution***: Consider the impact of the disguised sale regulations under § 707.

## Debt-Financed Distribution

Before the refinancing, the preferred capital account was a negative $40,000,000 and the capital account was $10,000,000. After the $6,000,000 partial redemption of the preferred interest, the negative capital account is now $46,000,000 and the capital account is $4,000,000 that is exposed to the estate tax.

Senior can take the $6,000,000 of cash received as a partial redemption and use it for additional estate planning for a high basis asset that does not need a step-up in basis at death.

| Partner | Tax Basis | Gross Value | Liability | Phantom Gain | Capital Account |
|---|---|---|---|---|---|
| Preferred | 4,000,000 | 54,000,000 | 50,000,000 | 46,000,000 | 4,000,000 |
| Common | 10,000,000 | 20,000,000 | None | None | 20,000,000 |

# What if the partnership desires to distribute the extra $6,000,000 from the refinancing to the grantor trust that now owns the common interest? Is this permitted?

- Senior should retain a small portion of the common interest to provide the flexibility to return the negative capital account common interest to Senior's estate for a step-up in basis at death.

# How to obtain a step-up in basis at death for the $10,000,000 value shifted to the grantor trust?

| Partner | Tax Basis | Gross Value | Liability | Phantom gain | Capital Account |
|---|---|---|---|---|---|
| Preferred | $2,000,000 | $54,000,000 | $44,000,000 | $40,000,000 | $10,000,000 |
| Common | $10,000,000 | $20,000,000 | None | None | $20,000,000 |
| Totals | | | | | $30,000,000 |