Mary Vandenack provides the transcript from Legal Visionaries podcast on Preferred Freeze Partnerships Part 1

TRANSCRIPT:

Mary: On today's episode, my guests are Jerry Hesch and Stephen Breitstone, and actually, what we're going to do is two episodes where they're going to discuss increasing the income tax and estate tax benefits for the preferred partnership with encumbered real estate with future leveraging. Jerry and Stephen are both at Meltzer, Lippe, Goldstein & Breitstone LLP. Jerry's out of Boca Raton, Florida, and Steve out of Mineola, New York. Thanks for joining me today, Jerry and Steve.

Jerry: Okay, thank you, Mary. Interestingly enough, if we look at the standard estate planning techniques, they all are designed to accomplish about four different objectives, and one of the objectives is financial leverage. For example, when you sell an asset to a irrevocable trust at the AFR and the AME trust earns more money than the AFR, it keeps the spread, and we call that financial leverage. All of the transactions... Remember GRATs are nothing more than a sale of an asset for an annuity. Installment sales a promissory note and in preferred partnerships, we end up selling the common interest to a trust for a note or something, so all of the standard estate planning techniques and gifts all can shift all or a portion of a partnership's income to trusts that aren't included in the gross estate. Okay?

All of these transactions all accomplish the second objective, which is all future appreciation and the value of the asset shifted to the irrevocable trust is now owned by the irrevocable trust and is not exposed to estate tax. Then the third advantage is what my friend Richard Oshins calls the burn and basically as a grantor trust, we all know that when the grantor has to pay income taxes on the trust income, that depletes the grantor's assets. So, for example, if the income is a million dollars and the taxes are $400,000, the trust nets a million and the grantor pays $400,000 out of its own pocket, and so we call that the burn and all the estate planning techniques basically accomplish this objective, okay? The problem is with a gift, it's carryover basis. With a GRAT, it's carryover basis and with an installment sale to a grantor trust, it's carryover basis, so you have the appreciated asset outside of the decedent's gross estate, so you can't get a step-up in basis at death.

Stephen: Let me just take a step back for a moment and say what is probably obvious to most people but needs to be said, nonetheless. All of these techniques are designed to greatly increase what can be transferred to a trust that's not in the estate or that are not part of the estate, but it's leveraging those exemptions. Just to do a straight gift limited to the lifetime exemption amount, with these techniques, you can leverage your exemptions almost to an unlimited extent. So that's why I guess it's said by some that these estate taxes are voluntary. If you do the right planning in advance, it can be avoided. These are some of the most prevalent techniques for doing that. We'd like to freeze partnership for certain types of assets. We'll go into that.

Mary: I just have a quick question. So would it be fair to say that a great estate planning strategy, regardless of which strategy, would combine using financial leverage, the freeze and the burn.

Stephen: All of the above.

Jerry: All of the above.

Mary: What you guys really like is the preferred partnership, and so we're going to talk a little bit more about that.

Jerry: Because what happens is a preferred partnership interest is an asset that's retained by the individual. So, when the individual dies with the preferred partnership interest as an asset in the gross estate, you get a tax-free step-up in basis at death and the income tax benefits can be supercharged when you have encumbered real estate, okay? The other thing is the problem with a GRAT or installment sale is the payments end and with the preferred partnership interest, you're getting a preferred return for the rest of your life, so in that situation, you can actually rely on an income stream for the rest of your life. The other thing is when the preferred partnership interest is included in the gross estate, it's usually a business interest that may be eligible to qualify for the deferred payment of estate taxes under code section 6166. So essentially, in that situation, what is a freeze partnership? It's a partnership with two classes of ownership interest. The preferred interest, which is entitled to a guaranteed payment or a preferred allocation of partnership profits for as long as you own your preferred interest and-

Stephen: The fixed return. That's the most important-

Jerry: Yeah. So the fixed return.

Stephen: A lot of the planning that we're going to get into this, no doubt, is about how to structure that fixed return so that it's as low as possible. It's subtle there. People have a tendency to call the freeze partnership a leaky freeze because the preferred return is going to be greater than your AFR, your applicable federal rate, so if you do your simple installment sale, the rate of return is going to be typically lower than with a freeze partnership. Some people say, "Well, that's bringing more back into the estate. Whatever's getting paid back is increasing the estate or reducing the extent to which it's decreased." That's all true, but it's not as true as people think it is, and we'll talk about how to structure that preferred return so that it's as minimally leaky as possible.

Jerry: Think of the preferred interest as the practical equivalent of a bond. A bond doesn't appreciate in value unless interest rates change. So, the preferred partnership is very simple. We bifurcate the partnership interest into a preferred and common and since the preferred is getting a guaranteed payment that will not change if the partnership income increases, all of the future appreciation and all of the income and the excess of the preferred return must be allocated to the common, so that's where the freeze comes in. So, we basically create a partnership with a preferred and common. The preferred interest is frozen in value. All future appreciation is allocated to the common interest. All income in excess of the preferred return or the preferred guaranteed payment is allocated to the common interest, and then Senior who owns both interests disposes of the common interest to an irrevocable trust in a typical estate planning transaction. It could be a gift, it could be a sale.

Stephen: You have to bear in mind with all of these techniques, whether it's a GRAT, an installment sale, freeze partnership, that there's a hurdle rate that has to be exceeded for them to really transfer wealth to the next generation, and the preferred return in this context is the hurdle rate. If the assets aren't generating enough of a return to pay the preferred return, then you're going backwards. You're not really accomplishing anything. However, again, we'll talk about different ways of minimizing the preferred return and also use of discounts to help to minimize the amount that has to be paid in respect to that preferred interest. By transferring discounted assets into the freeze partnership, which you're allowed to do in regs, you can minimize the effective return that has to be paid back and thus minimize the hurdle rate.

Jerry: Remember, because the preferred has a priority, it's almost like a creditor or like a bond, so if you terminate the partnership, you've first got to redeem all of the preferred until you can make any distributions to the common, but that's the quid pro quo. We're allocating all future appreciation and value to the common interest. Okay. So again, what are our objectives? To obtain an income tax-free basis to step-up at death. As we will discuss later at slides 23 and 24, we have this leaky freeze and how can we reduce the preferred rate of return, and we'll show you how that's done. The key here is the common interest that Senior is going to transfer in an estate planning transaction. That common interest is a common limited partnership interests, which can be discounted for valuation purposes. So that's where you can take into account the discount.

Stephen: There are two places. I just want to emphasize two places where your discounts come into play in structure and freeze partnership. First, if you're contributing an interest in an entity to the freeze partnership and it's structured so that it's non-voting and non-marketable, then that creates one layer of discounts, and that, again...you're not reducing the return that it's paying, you're just reducing the denominator and therefore, it enhances the ability to make those preferred payments. Then the second place is what Jerry just said. On the transfer of the common interest, you're allowed to transfer it in a transaction that also has discounts. Both of these points are clearly laid out in regulations under section 2701. This is nothing that's abusive, at least not that I think.

Jerry: Now here's something…

Mary: Can I just, for a second, restate what I think is obvious but I just think bears clarification? So, in this case, you're having the Senior feed the preferred and Steve has referred a couple times reducing that preferred return. The point of that is just because what we're doing that is staying in Senior's estate and we want the least possible in Senior's estate, so we don't want to have a big return that exceeds the amount that the assets are producing.

Jerry: Yeah.

Stephen: Exactly.

Jerry: Now here's what's interesting. The preferred interest is not a debt obligation. It's not an interest in the trust. It's an equity investment in an entity. Section 7520 applies to interest in trust. The AFR under 1274 only applies to then obligations. So, the Internal Revenue Service 40 years ago basically said that since the preferred interest is nothing more than an ownership interest in an entity, the rate of return on the preferred interest must be a market rate. As we know, section 7520 and 1274 use the AFR, which are below market rates. So that's why the preferred rate of return will always be greater than at market rates than the 7520 rate or the AFR. We see that interestingly enough, the current 7520 rate is 4.4%, the current AFR is 3.74%. So essentially, what this means is the preferred rate of return will be in the five to six or maybe even greater rate of return. Notice I give you the sites in the slides so you know where to go so you can look forward to it. The objective is how can we reduce the preferred rate of return because the preferred rate of return will always be a market rate greater than the transfer tax rates that we're using. Of course, we talked about the rest of the freeze, the discounted value. So, we give the common partnership interest away to an irrevocable trust and we also like everything to be in a grantor trust so that you can have the common interest create the burn for federal transfer tax purposes. Okay, now, so here's the key. Now, remember, I didn't start practicing law until about 15 years ago. For 25 years before that, I was a full-time law professor and I had the humbling experience of having to teach the basic income tax course to the fine arts majors of the world, and what I learned is it's not what you know, but your ability to communicate what you know in an understandable manner. What I discovered is rather than describe everything generically, we use simple to follow numerical examples. The most important lesson that I hope you get from today is not how to do a preferred partnership, but how to communicate whatever you're proposing in an understandable manner by using nice, simple to follow numerical examples. So, let's take a real simple situation. Senior has a business with an already discounted value of $20 million because it's not a marketable security. It's a closely held business. So, the closely held business Senior-

Stephen: By way of example, let's say that that closely held business is worth $21 million and it has voting and non-voting shares, typically in an LLC or partnership, and you're transferring the non-voting, non-marketable interests in the business, which just happened to be worth $20 million for the purposes of this example, into the freeze partnership in exchange for the preferred interests. So that is your discount going in.

Jerry: So somebody would buy the business from you maybe for $25 million, but because it's non-voting interest and it's not marketable, the actual value is $20 million. So Senior transfers this 99% non-voting interest to a new partnership with $20 million, taking back a $10 million capital account for the preferred interest and a $10 million capital account for the common interest, and because the preferred gets a priority allocation of profits, all profits must first be allocated to the preferred. In this situation, the preferred interest can provide for a 6% priority allocation of partnership profits, and interestingly enough, this statute has rather rigorous mechanical roles that tell you exactly how to structure your preferred partnership so that when you transfer the common interest, all the value, all the future increase in income and all the future appreciation will be in the common interest. In other words, 2701 has a roadmap of actually how to structure your preferred partnership.

Stephen: You can also, by the way, use a guaranteed payment. So, if you're familiar with subchapter K, partnership taxation, you can have payments to a partner that's determined without regard to the income of the partnership, that's right in the code and the regs, and that payment is deductible by the partnership and you can use that payment to satisfy the preferred return requirement, which is different from just an allocation of profits.

Jerry: Yeah, so basically the preferred return is 6%, which means 6% times $10 million or the first $600,000 of partnership income must be allocated to the preferred, and if you give the common away to an irrevocable trust, any income in excess of $600,000 each year is allocated to the common interest. For simplicity purposes, we're going to ignore any liabilities.

Mary: I just do want to ask a question. I don't want to complicate a simple example, so I'm going to try and ask in a way that allows for a simple answer. When you said the $20 million is a discounted value that's going into the preferred partnership, but we're transferring a preferred and common interest, so are we contributing that business has, there are difference in value between the preferred interest and the common interest?

Jerry: No, no. The discounted value. Someone would buy the business maybe for $25 million, but when you take into account lack of control, lack of marketability, the business has a discounted value of $20 million. So, I contribute that business to a partnership and my capital contribution to the partnership is $20 million, even though it could be worth $25 million.

Mary: So it's really doing, and I would just want to clarify is the discount is on the business itself prior to contribution considering whatever the appropriate discounts might be.

Jerry: Exactly.

Stephen: Right. So that you're discounting the value of the business, but the return the business is paying is not discounted. So therefore, it makes it much easier to meet that hurdle rate.

Jerry: All right. When you do a GRAT, you put your marketable securities into a GRAT and what do you give to the GRAT? A 99% limited partnership interest, which is already discounted, so the GRAT payment is based on the discounted value of the limited partnership interest you contribute to the GRAT.

Stephen: I've been doing these freeze partnerships for over 20 years. I don't think I had gray hair when I started and I learned a lesson the hard way. I was explaining freeze partnership to a woman who was considering an installment sale. The installment sale to the intentionally defective grantor trust is probably the most popular transaction for transferring interest in a business as opposed to…"Hey, man," she said, "Where's the discount?" Putting an interest in a piece of real estate into the freeze partnership. She said, "If I just did an installment sale, I would get a discount, right? That's the value of what you're selling, the discount," to which I said, "Well, we're going to put that interest into that real estate into an LLC and we're going to transfer a non-voting interest in the LLC into the partnership. There's your discount."

Jerry: So, what we have is a preferred interest with a $10 million capital account and a common interest with a $10 million capital account. Since all the increases above the $600,000 and all future appreciation is allocated to the common, we want to dispose of the common interest in an estate planning transaction to an irrevocable trust, and so you can gift it to the irrevocable trust, or you can sell it to the irrevocable trust for a promissory note. In order to avoid any income tax realization event, we want the sale to be a grantor trust so there's no income tax sale. So, what happens in this situation is the preferred partner can only get $600,000. If the income of the partnership goes above

$600,000, the preferred partner gets none of it, so the preferred is frozen at its $10 million capital account. Now here's what's interesting, if the partnership desires to redeem a partner's capital and you have a preferred and common interest, the preferred has a priority. If you're going to liquidate the partnership, you first have to redeem the preferred for its full capital account before you can make any distributions to the common, because remember…

Stephen: Talk about refinancings, Jerry. Just quickly about problems we run into with refinancing.

Jerry: No, that's going to be too confusing. Let's wait till the next hour.

Stephen: Okay.

Jerry: Okay. Now here's what's interesting. The preferred is like a creditor and the preferred is entitled to an allocation of the first $600,000 of partnership profits. So, what happens is suppose partnership profits for the first year are not $600 but $500,000. Well, all you have is $500,000 to allocate to the preferred. So there's 100,000 shortfall and under the statute, that $100,000 shortfall must accumulate in arrears and be satisfied in future years before any profit allocations can be made to the common partner, so if the preferred priority return is $600 and you only get $500 in the first year for the preferred, then the next year, the first $700,000 of partnership profits must be allocated to the preferred before you can allocate anything to the common.

Now the nice thing about the preferred...remember, in a GRAT or installment sale, you have to pay back the principle. In a preferred, the preferred is an ownership interest that can last forever. So, there is no requirement on the partnership while the preferred decedent is alive to ever redeem the preferred interest, unlike a GRAT or installment sale where you got to pay back the principle. Now, interestingly enough, because the preferred is a preferred equity interest, like a creditor, losses have to first be borne by the common partner. You can't allocate losses to the preferred return, which is something that, again, it's a fundamental partnership concept under the special allocation rules and partnerships right now. All right. Now, let us do an example with encumbered real estate. Let's take a simple situation.

By the way, since I can never remember the names of clients, everybody is Senior and Junior, okay? Because remember, after 25 years of teaching, you never had to remember names. All you had was a seating chart. So, let's suppose Senior purchased a commercial office building in '84 for $20 million, allocated $16 of the purchase price of the building and depreciated the building over 18 years using what was called the accelerated cost recovery method, so Senior basically has about a $4 million basis in the building in the real estate after the building is fully depreciated.

Now if the property appreciates in value, the building owner simply refinances the property and takes out the refinancing proceeds in excess of the old loan as an income tax-free loan. So, what happens is, if you look at the next slide, this is what we have today. This building was purchased for $20 million in '84. It is now 40 years later. The building is worth $54 million, and the building has been constantly refinanced over that 40 year lifespan, and the mortgage is now $44 million. The building is fully depreciated, you can't depreciate the land. So, the adjusted basis in this piece of real estate is $4 million, and since there's $44 million of debt, the equity in this building is $10 million.

Now what we have here is what we call phantom gain. There is $40 million of phantom gain because the liabilities are in excess of basis by $40 million.

Stephen: Why do you call it phantom gain?

Jerry: Because if you sell the property subject to the liability, how much cash are you going to get?

Stephen: You're not getting that $40 million.

Jerry: You're getting $10 million of cash, but if you sell the building subject to the liability, your amount realized is the $10 million of cash plus the $44 million of liability shifted to the buyer, so your amount realized is $54 million. The total income tax gain is $50 million, but you'll only have $10 million of cash, so you have gain with no cash. So, if you sell this building while you're alive, and let's assume that we're in one of my favorite states for income tax planning, California, because they have a wonderful state income tax rate of 13.3%, and the federal rate could be 20% or 23.8% because of the 3.8% net investment income tax surcharge. So, using this simple example, the effective state and federal income tax rate could be 37%. Well, 37% of $50 million is $18.5 million.

Stephen: It could be higher than this.

Jerry: What?

Stephen: It could be higher than this. You're assuming everything's taxing capital gains here.

Jerry: Yeah, I'm not going to complicate things. Trust me.

Stephen: It's more compelling in reality.

Jerry: All right, so assuming we-

Mary: If I can just comment that this is actually a really common scenario for real estate investors. So, you're trying to make it simple, but this actually... We see this a lot with those who've held real estate for a long time. I just have this one parcel, but they may have numerous parcels.

Jerry: Exactly. So essentially, the Senior says, "Wait a minute, I'm going to sell this building, get $10 million and owe $18 million of income taxes. No way." Suppose Senior basically dies never having sold the building. With a $54 million gross value, $44 million of mortgage. If Senior died with that building, with $10 million of equity and $50 million of potential income tax gain, what's included in Senior's gross estate? The $10 million of equity and we like...what's the advantage of having a 40% estate tax rate instead of a 37% income tax rate?

Stephen: You can do the math in your head of course.

Jerry: Exactly. So, my idea of tax reform is to increase the income tax rate from 37% to 40% so that it's easier to do the math. That won't go over, but that's my try.

Mary: I like that actually a lot. I'm going to steal that one from you.

Jerry: Okay, so essentially, wait a minute. If Senior died under the Supreme Court's decision in Crane versus Commissioner, Mrs. Crane took a basis in the property of $54 million. So, if Mrs. Crane turned around and sold that property for $54 million with a basis of $54 million subject to the mortgage, no gain would be reported and she would net $10 million of cash. So, a lot of real estate owners say, "Wait a minute. I'm not going to do any estate planning with my real estate and get it out of the estate with carry over basis. I want the step-up in basis at death." The problem is if Senior continues to hold the real estate until death, guess what? Senior is 70 years old. Senior expects to live another 15 years. What do you think is going to happen to that real estate over the next 15 years? It's going to go up from $54 million to a greater amount. So basically, in this situation.

Jerry: So Senior says, "Wait a minute. If I die today, I still have to pay $4 million of estate taxes," but remember, I just increased the basis to $54 million, so if I can allocate $40 million of that basis to the building, that creates $40 million of depreciation deductions and those depreciation deductions is going to offset ordinary income, and at a combined federal state income tax rate in California of 50%, the income tax savings from those future depreciation deductions are $20 million. So, Senior says, "I want to do this," but the problem senior has is...guess what? If he continues to own this property and that property goes from $54 million to $64 million and everything else stays the same, Senior's got $20 million in his gross estate. So, what we like to do is basically do a preferred partnership. What we're going to do is basically reallocate the ownership of that real estate into a preferred interest and a common interest. Section 2701 says, "When you have related parties or family members, you must allocate at least 10% of the capital of the equity to the common interest." So, if you go by the statute, Senior can allocate 10% of the capital to the common interest and 90% of the capital to the preferred interest. Well, under the partnership income tax rules, 90% of all the tax attributes must be allocated to the preferred and only 10% of all the tax attributes can be allocated to the common, so we do the traditional 90/10 allocation, look what happens. 90% of all of the income tax attributes are in the preferred that can disappear. The common interests can then be shifted away. Remember, the preferred is frozen at its $90 million capital account, which will never change. So, what happens is Senior gifts the common interests to a grantor trust and all the appreciation is in the grantor trust. Look what happens. Senior dies and guess what? 90% of the liabilities, 90% of the tax basis, 90% of everything is allocated to the preferred. So, you get a step-up in basis at death for the preferred of $48.6 million. The problem is the common interests. This lousy common interest, which you must have 10% of the capital in the common interests, that was enacted in the 1989 legislation. Has 10% of all the tax attributes, so even though you've shifted all future appreciation to the common, you don't get a step-up in basis for 10% of the gain including the phantom gain. So that is a problem that we have to deal with. By the way, Steve, let me ask you a very simple question. If I gift this common interest, instead of giving the common interest to a grantor trust, I decide to give that common interest outright to one of my children at a gift of a million dollars. Why is that an income tax disaster?

Stephen: Well, it's certainly an income tax realization. It's not a grantor trust. If it's a grantor trust, it's like you're giving it to yourself. You're giving it to your child... non-grantor trust. The liabilities in excess of basis, which are allocable to that common interest, will generate taxable gain.

Jerry: In other words, if I gave this as an outright gift to a non-grantor trust, so to my child, I would have to recognize $4 million of phantom gain. Now, the problem is this is all part income tax and most estate planners forgot all they learned in what we call baby tax, the basic federal income tax course. So always make sure when you transfer in the common interest, you want it to be in the grantor trust and the other reason you want it to be in the grantor trust is for the burn caused by the grantor paying all the income taxes. All right. So, in this situation-

Mary: Jerry, so what I was thinking is we are going to split this into two episodes, so I was thinking we could stop here and then start the second episode with the recap of the alternative one and then develop it from there. Would that be okay?

Jerry: Yeah. So, here's the key. Senior dies with only the frozen preferred interest, including in Senior's estate. The capital account is $9 million. By the way, the discount for a preferred interest is significantly lower than a non-voting common interest. You'll find that if the common interest could be discounted, say, at 25-30%, the preferred interest at best can only be discounted at about 10% because the preferred has a guaranteed payment. So basically, at this situation, let's take a little bit of a break. It's a nice stop off point because what we're going to show you starting with the next session is how I can have all the tax attributes, all the liabilities in the preferred interest, so the common interest has none of those phantom gain or negative capital accounts.

Mary: Okay. So, I want to thank Jerry and Steve for joining me for the first episode where we're discussing the preferred partnership freeze strategy, and we're going to continue the discussion in episode two, but as reach the end of this episode, I want to thank our sponsors InterActive Legal, Carson Private Client and Foster Group. We will continue with episode two, so thanks for listening and stay tuned.