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ESTATE TAX MEMORANDUM

TO: **CPAs, Clients & Associates**

FROM: **David L. Silverman, Esq.**
Shirlee Aminoff, Esq.

DATE: **April 7, 2010**

RE: **Family Discount Entities: Income Tax Considerations**

FLPs (and LLCs) are ideal holding entities for family assets since fractional discounts yield substantial transfer tax savings. While the income tax treatment of asset transfers to and from these "flow thru" entities is generally placid, income tax planning should not be relegated to a mere afterthought.

IRC Secs. 721 and 731 generally confer nonrecognition status on most asset transfers to and distributions from FLPs. The operative word here is "generally." Case in point: § 721(b) requires recognition when appreciated property is contributed to a partnership (i) 80% of the value of whose assets, immediately after the transfer, are held for investment, and consist of stock, securities and money, if (ii) "diversification" resulted from the transfer. (Rev. Rul. 87-9 opined that 5% diversification is de minimus, while 11% diversification produces a taxable event.) Note that the 80% test can be satisfied, and gain recognition can be required, if real estate is contributed to a

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partnership holding only securities, since the test measures the mix of property held by the partnership immediately after the transfer, without regard to the property contributed.

Distributions of appreciated property are tax-free to the distributee partner under §731(a), except to the extent money distributed exceeds the partner's basis in his partnership interest. Many family entities hold title to marketable securities. A distribution of marketable securities by a family entity could trigger gain under § 731(a), since § 731(c) thoughtfully provides that the term "money" includes "marketable securities." However, §731(c)(3)(A)(i) tempers this harsh rule by exempting from the definition of money appreciated securities which had been contributed to the partnership by the partner receiving the distribution. The declaration of § 731 defining marketable securities as money does not stand alone in its attempt to erode the general rule of nonrecognition: other Code provisions stand as sentinels attempting to deny tax-free treatment in a variety of distribution transactions.

One such provision narrowing the scope of nonrecognition is § 707(a)(2)(B), which recasts nominal § 721 tax-free contributions and § 731 tax-free distributions into constructive sales by the "contributing" partner if the transfers "viewed together" are "properly characterized" as a sale or exchange. Thus, a partner who receives cash immediately after contributing appreciated real estate could be treated as if he had sold the property to the partnership. Regs. § 1.707-3(c)(2) requires disclosure of such transfers within two years of one another. Regulations under § 707 do allow that if the contribution and distribution are more than two years apart, the transaction will be presumed not to be a sale of the property to the partnership.

Another provision which further attenuates the general rule of nonrecognition on property distributions is § 704(c)(1)(B), which provides that if a partner contributes appreciated property and, within 7 years, such property is distributed to another partner, the contributing partner is taxed on the contributed property's built-in gain as if it had been sold by the partnership.

Closely related to § 704(c)(1)(B) is §737, which focuses its gaze not on the effect of distributions involving previously contributed appreciated property to another partner but rather, on the effect of distributions to the partner who himself contributed such property at an earlier time.

IRC § 737 thus provides that a partner who contributes built-in gain property to a partnership must recognize the remaining net precontribution gain to the extent the value of other property distributed to him within 7 years exceeds the adjusted basis of his partnership interest immediately before the distribution.

Transfers of property subject to debt can also cloud transfers to family entities. A gift of property whose debt exceeds basis results in gain recognition under Regs. § 1.1001-2 to the extent of the difference. Thus, a gift of real estate worth $1 million, with basis of $250,000, and which is subject to a nonrecourse mortgage of $500,000, would result in $250,000 of realized gain to the transferring partner.

To vanquish the gain problem in this situation, the transferor might consider a "freeze" partnership instead of a discounted gift transaction. Thus, with respect to the property in the preceding paragraph, the parent could contribute the real estate worth $1 million to an LLC in exchange for membership interest with a liquidation preference equal to the equity in the property, or $500,000, and also retain the right to (i) an annual return of 8% on the liquidation preference and (ii) 10% of any profit and gain in excess of the liquidation preference. The transferor's children could contribute a small amount of capital in exchange for an interest providing them with 90% of the profit and gain in excess of the transferor's priority return.

Assuming the transaction were not to run afoul of the rules in IRC § 2701 et seq. (Chapter 14) which require the priority return to constitute a "qualified payment" — and there is no reason why it should — the real estate could be contributed to the partnership without a deemed relief of liabilities and its attendant gain recognition. Note that in this transaction, no gift will have been made; thus, the technique could be ideal for a person who has already depleted his or her entire gift tax exemption amount. If the transferor holds the "frozen" membership interest until his or her death, the heirs would receive a step-up in basis, and 90% of the appreciation in the real estate would have been transferred out of the parent's estate.

The "preferred" limited partnership (PLP) "freezes" the value of preferred interests held by the transferor. Generally, the preferred interests must have a value immediately following their issuance equal to the property contributed. In contrast, a typical FLP is entitled to a large discount upon formation at the cost of a current gift tax liability. Often, this gift tax liability can be shielded from current tax by the applicable exclusion amount.

From a discounting perspective, the FLP is superior to the PLP upon formation. Thereafter, to the extent the FLP assets appreciate, the value sought to be removed from the transferor's estate may "leak" back into the transferor's estate. Accordingly, while the FLP may hold an initial advantage, if the expected total return of the asset substantially exceeds the cash-flow preference of the preferred partners, the PLP may ultimately be superior to the FLP.

The Charitable Lead Trust (CLT) is a trust in which the donor gives an income interest to a charity and, upon the donor's death or after a term certain, a remainder interest passes to noncharitable beneficiaries. In essence, the donor is "lending" the assets to the charity for the term of the trust. Since the gift tax exemption is scheduled to remain at $1 million indefinitely, CLTs may enable charitably-inclined individuals to make substantial lifetime transfers without incurring a current gift or estate tax liability, thus preserving wealth for future generations.

Moreover, the current low interest rate environment is exceptionally hospitable to the CLT. As with a mortgage, the grantor of a CLT may "lock in" the favorable interest rate used to determine the gift and estate tax cost of the arrangement. To fund a CLT, the donor gifts property into a trust which provides an income interest to a qualifying charity for a determinable period (e.g., a term of years or life of an individual) and a remainder interest to one or more noncharitable beneficiaries. The property may consist of cash, stock, income-producing real estate, or interests in a closely-held family business. For gift tax purposes, a gift of (i) a present interest is made to the charity and (ii) a future interest is made to the noncharitable beneficiaries. A gift tax deduction is available only for the gift of the present interest to the charity. The larger the nontaxable gift to the charity, the smaller the taxable gift to the remainder beneficiaries.

For income tax purposes, since the CLT is a separate taxpayer, no income tax deduction will be available to the donor for gifts made to the CLT. However, an exception to this rule exists if the CLT is a grantor trust. In that case, an income tax deduction would be allowed since the grantor (donor) will pay income taxes associated with the trust. Grantor trust status may or may not be acceptable to the donor.

Congress requires annual payments to the charity of either (i) a fixed annuity or (ii) a payment consisting of a percentage of the fair market value of the trust assets. This rule prevents donors from investing trust assets in low-income investments which would diminish the present income interest of the charitable beneficiary. Increasing the size of the annuity reduces the size of the taxable gift to noncharitable beneficiaries.

For gift tax purposes, the present value of the annuity or unitrust interest depends on the IRC § 7520 rate (120% of the mid-term AFR) which is 3.6% for June 2003. Ultimately, what is removed from the donor's estate is the growth of trust assets in excess of the Section 7520 rate. Therefore, like GRATs, CLTs work best in low-interest rate environments. Unlike GRATs, however, CLTs can be zeroed-out at inception with no initial taxable gift by providing for a sufficiently high annuity. Nevertheless, like a GRAT, if trust income is insufficient to pay the annuity, invasion of principal will be required. Selecting a high annuity amount to decrease the size of the taxable gift works if the property generates income sufficient to actually pay the annuity. Invasion of principal, if required to subsidize the annuity payment, would naturally reduce the amount ultimately passing to noncharitable beneficiaries.

To illustrate the mechanics, a CLT is funded with $500,000 in stock, providing for a 6% annuity to a named charity for 20 years, after which the trust will terminate and pay the remaining balance to the donor's children. Assume (i) the assets will appreciate at a rate of 5%, and (ii) the donor has fully utilized his gift and estate tax exemption, meaning that any further gifts would result in a current tax liability or a future estate tax liability.

If the assets were simply invested, the donor's taxable estate in the year 2023 would be $3.91 million, of which $1.79 million would be required to pay estate tax, leaving $2.11 million available for distribution. With a CLT, the taxable estate would be $1.43 million, of which $0.53 million would be required to pay estate tax. The lead trust assets, now worth $1.51 million, would pass to the children at no estate tax cost, having been removed from the estate in 2003. The net estate available for distribution would be $2.38 million, $270,000 more than what would have been available for distribution had the assets simply been invested.