

Special Session IV-C

Getting Your Hands Dirty with Real Estate Investors

Closely-Held Business Planning Series

Farhad Aghdami

Williams Mullen
Richmond, Virginia

Sarah Moore Johnson

Birchstone Moore LLC
Washington, D.C.

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**Sarah Moore Johnson
Birchstone Moore LLC
Washington, DC**

**Farhad Aghdami
Williams Mullen
Richmond, Virginia**

This outline addresses many of the planning issues unique to real estate throughout the life cycle of an estate – from the acquisition of real estate in an investment portfolio, to the gift, income and non-tax implications of holding and transferring real estate during life, and finally on to the tax and non-tax implications of holding real estate investments at death.

I. STRUCTURING OWNERSHIP OF REAL ESTATE

A client investing in real estate may question whether such real estate is better suited being owned by an entity rather than by the client individually. Before jumping to a recommendation of taking ownership through an entity, consider the relative advantages and disadvantages of individual ownership versus entity ownership.

A. Individual Ownership

1. Advantages

There are several advantages to individual ownership that are sometimes overlooked, such as:

- a. Lower start-up costs, in that there is no need to pay formation fees to a secretary of state's office, no registered agent fees, and no legal fees for drafting organizational or trust documents.
- b. Accounting is simpler, as there is a single set of books and tax returns for the individual taxpayer.
- c. There is a single income tax imposed on income received from the property (although this can also be achieved with several types of entities), and the individual property owner generally can utilize depreciation and other income offsets, which could be lost if the real property is owned by a corporation. It should be noted that the default classification of a single-member LLC is treated as a disregarded entity and can achieve the same result, with a single income tax being levied at the individual property owner's level.
- d. There are no concerns with partnership tax and corporate tax issues.
- e. Managing the real estate on a day to day basis is simpler, as there is no need to maintain separate entity-level bank accounts, no corporate formalities to follow, and no annual reporting to the secretary of state.
- f. It is easier to sell the real estate, as negotiation of a stock sale versus an asset sale is not necessary, and the seller's contractual representations and warranties to the buyer are less complicated.

2. Disadvantages

The disadvantages of individual ownership of investment real estate are more frequently publicized, and include:

- a. Exposure to personal liability. If investment real estate is owned by an individual and not by an entity, the individual should review his or her personal liability or umbrella insurance policy to ensure that the coverage is adequate given the increased risk. Inviting third parties to enter real estate owned by the client brings heightened risk of many types of legal claims, including landlord-tenant issues, structural accidents, environmental hazards, trespassing, and accidents from negligence, disasters or terrorism.
- b. Inclusion of the real property in the individual's probate estate or requiring probate in each jurisdiction where property is owned.

- c. Lack of privacy, in that the individual's name will be able to be searched in a land records office, and a search of the address will reveal the name of the property owner.
- d. Inflexibility in bringing in other investment partners who will likely insist on the liability protection of an entity or who may want to create different classes of ownership or voting rights.
- e. Potential creation of ordinary income as dealer when capital gains might otherwise apply (See Article III, *infra*).

B. Forms of Non-Entity Ownership

If a client decides that individual ownership is best for their situation, the client may still invest in the real estate in conjunction with other individuals, in which case, ownership can take three forms: (i) tenants in common, (ii) joint tenants with a right of survivorship, and (iii) tenants by the entirety.

1. Tenancy in Common

Tenancy in common allows more than one taxpayer to take title to a property without forming a separate entity. Each tenant in common owns an equal or unequal undivided fractional interest in the entire property. A tenant in common may sell or otherwise transfer his interest in the property, and the transferee becomes a co-tenant with the other tenants in common.

For example, if three investors pool their funds to buy 100 acres, with the three owners receiving 25%, 35% and 40% ownership interests, the 25% owner has not purchased 25 acres but rather one-fourth (1/4) of the entire 100 acres. Because each of the three investors is entitled to use the entire 100 acres, it is recommended that tenants in common enter into a Co-Tenancy Agreement to spell out the rights and responsibilities of each owner.

a. Right to Partition. Tenants in common generally have a state law right to partition the property. The Internal Revenue Service ("IRS") has taken the position that a partition by tenant in common owners of a single parcel of real property into separate, wholly-owned parcels of approximately equal value would not result in any gain because they would not be considered sales or exchanges.¹ However, if tenant in common owners of multiple, non-contiguous properties change their ownership of the parcels so that each owner becomes the sole owner of one of the parcels, it would not be tax-free unless it qualifies as a tax-free exchange.²

b. Who Deducts Interest and Expenses. One item that should be addressed in a Co-Tenancy Agreement is the reporting of income and expenses of the property by the partners on Schedule E of their respective IRS Forms 1040. Without an agreement, the rule of thumb is as follows: (i) When property owners have a right to seek reimbursement from their cotenants, taxpayers can only deduct expenses in proportion to their respective ownership interests. The Tax Court has stated, "It is well settled in this Court that expenses for which there exists a right of reimbursement are not 'ordinary and necessary,' and thus are not deductible."³ On the other hand, where an obligation runs with the land, such as real property taxes and mortgage indebtedness, the co-tenants are jointly and severally liable to protect their interest from a tax lien or foreclosure and, as such, the co-owner(s) who actually paid the expenses are able to deduct the entire amount of expenses paid, even if the amount exceeds the co-owner's pro rata share.

c. Right of Reimbursement Cases. *Estate of Boyd v. Comm'r*⁴ is frequently cited for the proposition that maintenance and repair expenses, if required, are properly payable by each co-owner in proportion to their ownership interests. In *Boyd*, the taxpayer owned a 50% tenant in common interest in rental real property and paid 100% of the expenses. The taxpayer reported 50% of the income and 100% of the expenses. The Tax Court ruled it was "well-

¹ See PLR 200411022 (Mar. 12, 2004); see also PLR 200303023 (Jan. 17, 2003).

² See PLR 199926045 (July 6, 1999) (finding that transfer of an undivided one-half interest in 39,000 acres of timberland, consisting of approximately 120 parcels, to a related company in exchange for ownership of 100% of one-half of same timberlands qualified as a like-kind exchange).

³ *Conte v. Comm'r*, T.C. Memo. 1981-571, referencing *Levy v. Comm'r*, 212 F.2d 552 (5th Cir. 1954); see also *Estate of Boyd v. Comm'r*, 28 T.C. 564 (1957).

⁴ 28 T.C. 564 (1957).

settled” (citing the Restatement on Restitution) that the taxpayer had a right to be reimbursed for the expenses from his co-owner, and the taxpayer could have sought reimbursement through the rental income.⁵

d. Joint and Several Liability Cases. In *Conroy v. Comm’r*, the Tax Court stated, “As a general rule, taxes are a lien on the land which both tenants in common are equally bound to discharge. The same would be true of a mortgage debt on the land.”⁶ As a result, when the taxpayer in *Conroy* paid 100% of the real property taxes on property he shared as cotenants with his daughter, the Tax Court ruled he was paying his own obligation, not a share of his daughter’s, and he was entitled to a deduction of all of the real property taxes actually paid by him.

e. Similarly, in *Powell v. Comm’r*, real property taxes were distinguished from insurance, repairs and maintenance expenses.⁷ The taxpayer in *Powell* owned a one-sixth (1/6) tenant in common interest in real property with her five siblings. The Tax Court held that the real property taxes are an obligation of the property, not of the owner. If the taxes are not paid, the government takes title to all of the property, not just the fractional portion of property attributable to the owners who have not paid. Thus, in *Powell*, the taxpayer had to pay the entire real property tax bill in order to protect her interest in the undivided property. As a result, the taxpayer was entitled to deduct the entire amount of real property taxes paid by her, not just her one-sixth (1/6) share.⁸

f. Mortgage Interest Deduction. There are cases where the Tax Court has taken the position that the mortgage interest deduction must be allocated pro rata among the cotenants, regardless of who pays the mortgage.⁹ In certain of these cases, divorced spouses had agreed that alimony payments would be used by one party to pay 100% of the mortgage interest and principal on property that continued to be owned by the divorced parties as tenants in common. In these cases, the Tax Court deemed each party to have paid half of the expenses.¹⁰

g. Depreciation. Depreciation of the property is taken by the owners in proportion to their ownership of the property.

h. Profits and Losses. Gain or loss realized on the sale or other disposition of the property is also divided among the tenants in common in proportion to their respective ownership interests.

i. Co-Tenancy Agreements. When parties own real property together as tenants in common, it is helpful to spell out the rights and responsibilities of each tenant in a Co-Tenancy Agreement. Some of the provisions properly covered in a Co-Tenancy Agreement include:

(1) Occupancy. If the property is to be occupied by one or more or all of the cotenants, the agreement can create rules regarding which tenant has a right to occupy the property and when, whether guests are permitted, and whether the property can be rented or subleased. If a cotenant is to occupy the property, the agreement can specify which expenses of occupancy are to be paid by that cotenant.

(2) Rental Income. If rental income is received, the agreement should explain how such income is applied. For example, the agreement could specify the priority of application as follows: (i) first, to pay the interest and principal due on any debt secured by the property, (ii) second, to pay any costs and expenses attributable to the routine maintenance and repair of the property, including, without limitation, utilities, insurance and real property taxes, (iii) third, to pay for any improvements to the property if agreed upon by the cotenants, and (iv) fourth, any remaining rental income is to be distributed to the cotenants in pro rata shares.

(3) Management of the Property. The cotenants should determine who will manage the property. One or more of the co-tenants could perform this task, with or without compensation, or the task could be delegated to a third-party property management company. If the latter, the agreement should spell out who makes the decision to hire and fire the property management company.

⁵ See also *Conte*, T.C. Memo. 1981-571; see also *James v. Comm’r*, T.C. Memo. 1995-562 (finding tenant is entitled to be reimbursed by his co-tenant for repairs, mortgage interest and other expenses, and can only deduct his 50% interest).

⁶ T.C. Memo. 1958-6.

⁷ T.C. Memo. 1967-32.

⁸ But see *James*, T.C. Memo. 1995-562 (holding that the real property tax deduction must be claimed pro rata under Pennsylvania law, which does not divest a co-tenant of his co-tenancy interest on account of his co-tenants’ failure to pay their proportionate share of the taxes).

⁹ See *Cothran v. Comm’r*, 57 T.C. 296 (1971); see also *James*, T.C. Memo. 1995-562.

¹⁰ See *Cothran*, 57 T.C. at 296; see also Rev. Rul. 62-39, 1962-1 C.B. 17.

(4) *Decision-Making.* The agreement could allow one co-tenant to make small expenditures without the consent of the others, up to a maximum dollar amount. Or the agreement could provide that unanimity, a majority vote or a super-majority vote is required for some or all decisions.

(5) *Maintenance.* The agreement can provide what state of repair the property is to be kept in, i.e. average, good or excellent.

(6) *Cash Shortfalls.* The agreement should include a provision similar to a “capital call” that requires each cotenant to contribute to the payment of property expenses, mortgage payments and taxes pro rata if the rental income is insufficient to cover such expenses. Some agreements provide that if the cotenants pay expenses in proportions that are not pro rata with respect to their ownership interests, the ownership interests can be readjusted in favor of the paying parties. Other agreements require the co-tenants to seek a loan from a third party or from another co-tenant.

(7) *Right of First Refusal and Buy-Out Provisions.* The Co-Tenancy Agreement can require a cotenant who wishes to liquidate his or her interest to offer it to the other cotenants for purchase before bringing a partition suit. Some agreements waive the right to partition altogether and require a buy-out or else the entire property will be sold. The agreement can specify how fair market value is to be determined, and what discounts are to be applied in determining the value of a selling cotenant’s interest.

(a) A tenant in common also may effectively waive his or her partition rights without resulting in a partnership. See, e.g., *Prude v. Lewis*, 78 N.M. 256, 430 P.2d 753 (1967); but see *Condrey v. Condrey*, 92 So.2d 423 (Fla. 1957).

(b) See PLR 200625009 and 200625010 (March 1, 2006), finding that a buy-sell procedure as an override on a tenant in common's right to sell its interest was acceptable.

(8) *Death of a Cotenant.* The agreement can specify whether a deceased cotenant’s share is permitted to pass pursuant to his or her estate plan, or whether the other cotenants have a right to purchase the deceased cotenant’s interest before it can be transferred. Alternatively, the agreement can restrict the class of permitted recipients of a deceased cotenant’s interest.

(9) *No Partnership.* Whether it is effective or not, the cotenancy agreement should also include a provision stating that the cotenants do not intend to create a partnership, for reasons discussed below. The following language could be useful:

No Partnership or Joint Venture. Neither the execution of this Agreement, nor any agreement to share in the obligations, distributions, profits or losses arising from the ownership of the Property, is intended to be, nor shall it be construed as, the formation of a partnership or joint venture or similar entity or undertaking among the Co-Tenants. Each Co-Tenant is the owner, as a tenant-in-common, of his, her or its, respective Percentage Interest in the Property. Except as otherwise expressly set forth herein or as agreed by subsequent written agreement, no party hereto has or shall have any authority to bind or otherwise act as the agent of the other party hereto, and all transactions, contracts, agreements and other undertakings made or entered into with respect to the Property will only be binding on any party hereto to the extent that such party has consented (or is deemed to have consented) thereto.

j. Avoidance of Partnership. If a property is owned by tenants in common and those tenants in common actively manage the property, there is a risk that the IRS may claim that a partnership exists. This can be detrimental for several reasons: (i) any condemnation proceeds received would need to be reinvested at the entity level and not by each cotenant individually; (ii) tax reporting is more complicated, requiring the filing of a partnership tax return and K-1 for each owner; (iii) it may prevent different taxpayers from using different rates of depreciation for their respective interests in the property; and (iv) significantly, the owners may be unable to engage in Section 1031 transactions, as discussed below. The Treasury Regulations provide:

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain

surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.¹¹

This “separate entity” would be a partnership if no election has been made to be treated as a corporation.¹² Note, however, that Section 761(a) allows the members of a partnership to elect out of Subchapter K under certain circumstances.

(1) See *Demirjian v. Commissioner*, 457 F.2d 1 (3rd Cir. 1972), where the Tax Court held, and Third Circuit affirmed, that tenants in common property owners were denied relief under the involuntary conversion rules of Section 1033 because they operated as a partnership.

(2) See also, *Levine's Estate v. Commissioner*, 72 T.C. 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980), where the taxpayer held properties as a tenant in common with another person, the court accepted the contention of the Service that, because such tenants in common “engaged in an active business, performed various services, and shared the gains and losses”, they were “engaged in the operation of a partnership”.

(3) In PLR 8916034 (January 23, 1989), individuals owning rental real estate were determined to be partners where proceeds from the sale of the property were deposited in the name of a partnership and a partnership tax return was filed in the year of sale.

k. Avoidance of Gift Tax Issues Associated with Rent-Free Use of Real Estate. Assume a parent allows her child to live rent-free in a residence owned by the parent. The fair market value rent of the residence (according to Zillow) is \$5,000 per month. The client is concerned that the rent-free use of the residence is a \$60,000 annual gift to the child; let alone the real estate taxes, insurance, and repairs that the client is also paying. A solution to this concern is to have the parent gift the child a small (say 1% to 5%) tenant in common interest in the property. Under common law, each co-tenant has the right to occupy the entire property, all of the time. In this case, a small gift (perhaps subject to a cotenancy agreement) may inoculate the client from a large (and compounding) gift tax liability.

2. Joint Tenants with a Right of Survivorship

When property is owned by more than one individual as joint tenants with a right of survivorship, each tenant is considered to have an undivided interest in the entire property, such that when one tenant dies, title is seamlessly and immediately vested in the other joint tenants. However, a joint tenant may, in most jurisdictions, freely dispose of his interest, thereby breaking the joint tenancy, in which case the transferee becomes a tenant in common with the other tenants, who may still own their ownership interest as joint tenants with a right of survivorship. In most jurisdictions, a joint tenant does not have partition rights, but a tenant in common has such rights.

Each joint tenant is required to report his share of any income or losses produced by the property.¹³ However, the expenses incurred on or with respect to the property are deductible only by the joint tenant who pays them, on the theory that the joint tenant incurs joint liability for all expenses with respect to the property.¹⁴

3. Tenants by the Entirety

It has been said that, “An estate by the entirety is an almost metaphysical concept which developed at the common law from the Biblical declaration that a man and his wife are one.”¹⁵ Tenancy by the entirety is similar to joint tenancy with right of survivorship in that the surviving spouse acquires title from the deceased spouse by operation of law, and the ownership is co-equal. The tax impact is the same as that of a joint tenancy with right of survivorship.¹⁶ The key differences between joint tenancy with a right of survivorship and tenancy by the entirety is that (i) tenancy by the entirety is only available to married couples and (ii) it offers varying degrees of protection from creditors, where the creditor has a claim against only one spouse to the marriage.

¹¹ § 301.7701-1(a)(2).

¹² See Treas. Reg. § 301.7701-3(a).

¹³ See *Haynes v. Comm'r*, 7 B.T.A. 465 (1927).

¹⁴ See *Tracy v. Comm'r*, 25 B.T.A. 1055 (1932); see also Rev. Rul. 71-179, 1971-1 C.B. 58.

¹⁵ *U.S. v. Gurley*, 415 F.2d 144, 149 (5th Cir. 1969) (interpreting Florida law).

¹⁶ See Rev. Rul. 71-268, 1971-1 C.B. 58; see also Rev. Rul. 75-347, 1975-2 C.B. 70 (holding that married taxpayers filing separate returns were each required to deduct half the amount of a casualty loss resulting from damage to their residence which they owned as tenants by the entirety).

1. Creating the Tenancy. States differ in how a tenancy by the entirety is created. In some states, as long as the deed indicates that a husband and wife or spouses are the grantees to real property, a tenancy by the entirety is automatically created and no more precise language is needed.¹⁷ In other states, there must be some indication of survivorship rights, or else the married couple are deemed to take title as tenants in common.

2. Varying Degrees of Creditor Protection. With the passage of the Married Women's Property Acts in the late 19th century, which granted women distinct rights with respect to marital property, most states either abolished the tenancy by the entirety or altered it significantly.¹⁸ Different types of altered statutes emerged, resulting in varying degrees of creditor protection:¹⁹

a. *Full Bar States.* The statutes in full bar states maintained the “oneness” of the tenancy so that neither spouse can act unilaterally. Because the consent of both spouses is required to take action with respect to the property, states with these types of statutes offer a full bar to the creditors of one spouse from acquiring an attachable interest in the entirety property. Some of the “full bar” states include Delaware, District of Columbia, Florida, Hawaii, Indiana, Maryland, Michigan, Mississippi, Missouri, North Carolina, Pennsylvania, Vermont, Virginia, Wyoming.²⁰

b. *Modified Bar States.* The statutes in modified bar states gave parity to the wife so that she, like her husband, can alienate part of the tenancy during her lifetime. Because either spouse can act, states with these types of statutes offer only a modified bar to the creditor's claims of one spouse. A creditor of one spouse can receive some rights in the entirety property, but in exercising the rights, the creditor must accommodate the non-debtor spouse's interest in the property. Some of the “modified bar” states include Alaska, Arkansas, Kentucky, Massachusetts, New Jersey, New York, Oklahoma, Ohio, Oregon, Rhode Island, Tennessee.²¹

c. *Variations on Modified Bar.* In some of the modified bar states, a creditor can levy and sell the property or order a partition.²² In other modified bar states, the creditor must lay in wait until the property is sold, or the tenancy is severed by divorce or death of the non-debtor spouse.²³ Other modified bar states exempt the homestead property from sale but allow a forced sale of other types of property.²⁴

d. *Limitations on Creditor Protection.* Titling property as tenants by the entirety is not a complete bar to creditors. Following are instances where the property is not protected, even in full bar states:

(1) If one spouse causes an automobile accident in a car owned by both spouses, both spouses will likely be liable and the tenancy by the entirety property becomes subject to claims of creditors.

(2) If the spouses divorce or if one spouse dies in the middle of a proceeding brought by a creditor, the tenancy by the entirety is severed.

(3) Federal Tax Liens. The federal government is entitled to levy and sell property subject to a federal tax lien, regardless of whether it is the liability of only one party to the marriage, and regardless of whether the property is located in a full bar state or a modified bar state. The leading case for this proposition is *United States v. Craft*, where the Supreme Court examined this very issue and held that the debtor spouse's interest in tenants by the entirety property is an interest in property for purposes of the federal tax lien statute, and thus subject to levy and sale by the federal government.²⁵ In *U.S. v. Cardaci*, the Third Circuit stated: “State-created exemptions [to creditor's claims] are swept

¹⁷ See *Estate of Goldberg v. Comm'r*, T.C. Memo. 2010-26 (holding that, under New York law, prior to decedent's wife's death, decedent and his wife owned certain properties as tenants by the entirety even though deed did not specify the precise type of tenancy).

¹⁸ R. Powell & P. Rohan, 7 REAL PROPERTY § 52.01[2] (M. Wolf ed. 2001).

¹⁹ See generally, Fred Franke, *Asset Protection and Tenancy by the Entireties*, 34 ACTEC Journal 210 (Spring 2009) (including an Appendix listing state by state variations in asset protection among the jurisdictions recognizing tenancy by the entirety).

²⁰ *Id.*

²¹ *Id.*

²² See Alaska Stat. §§ 09.38.100(a)-(b) (providing that a creditor of one spouse “may obtain a levy on and sale of the interest” of the debtor spouse and force partition or severance of the non-debtor spouse's interest; subject, however, to other exemptions such as the homestead exemption).

²³ See, e.g., *Morris v. Solesbee*, 892 S.W.2d 281, 282 (Ark. Ct. App. 1995) (holding that the purchaser of the interest of one tenant by the entirety cannot oust the other tenant from possession and can only claim one-half of the rents and profits, and that the remaining tenant is entitled to possession plus one-half of the rents and profits and the right of survivorship is not destroyed or affected).

²⁴ Mass. Gen. Laws Ch. 209, § 1.

²⁵ 535 U.S. 274 (2002).

aside by the Supremacy Clause of the Constitution, which ‘is as potent in its application to innocent bystanders as in its application to delinquent debtors.’”²⁶

(4) Bankruptcy Laws. The Bankruptcy Code provides two different categories of exemptions from creditors’ claims. Under 11 U.S.C. § 522(b)(2), a debtor may elect the specific federal exemptions listed in § 522(d) (“federal exemptions”) or, under 11 U.S.C. § 522(b)(3), a debtor may choose the exemptions permitted under state law and general (non-bankruptcy) federal law (“general exemptions”). A debtor may choose whether to use the federal exemptions or the general exemptions, unless the debtor’s state has “opted out” of the federal exemptions category. Real property titled as tenants by the entireties in a full bar state is protected in bankruptcy if the debtor chooses to use the general exemptions rather than the federal exemptions.

C. Choice of Entity

If the client decides that the real estate investment is best suited for entity ownership, the choice is generally between a C corporation, an S corporation, a partnership (general or limited), and a limited liability company (an “LLC”). The LLC is the most frequently used entity in real estate transactions because of its combined attributes of creditor protection, flexibility, succession planning, and avoidance of double taxation.

1. Non-Tax Considerations

Using an entity structure allows for the following benefits:

a. Pooling of Assets. Multiple investors can pool their wealth and achieve greater buying power than an individual investor. The bylaws of a corporation or partnership, or the operating agreement of an LLC, provide a clear set of rules that give the investors comfort not typically achieved by joint individual ownership.

b. Management Control. The entity’s governing document can provide clear guidelines for how the property will be managed and who will manage it.

c. Ownership Succession. The owners can impose rules on whether successor owners have voting or management rights or whether an original owner’s interest can be transferred without first giving the other owner(s) an opportunity to purchase it. This allows a matriarch or patriarch to ensure that a family property stays within the descendant line and is not transferred to in-laws or sold to third parties.

d. Valuation Discounts. The value of a 50% or less interest in a closely-held entity is usually subject to a discount for lack of control, and any interest in a family-owned entity is usually eligible for a discount for lack of marketability if the governing document contains restrictions on transfer. These valuation discounts allow taxpayers to leverage their estate and gift tax exemptions by reducing the value of the owner’s pro rata interest in the entity’s underlying assets.

2. Creditor Remedies

One of the main reasons for investors to use an LLC or a partnership is creditor protection, from both creditors of any property inside the entity and creditors of the investors in the entity.

a. Inside Creditors. If a claim is brought on account of property owned by an entity (an inside creditor), the claim will only extend to the general partner’s assets (if it’s a partnership), or, if the general partner is a corporation or LLC, to such entity’s assets. As a result of the general partner’s liability, general partnerships are rarely used today. Sometimes, a general partnership is required by an equity partner in a real estate deal (who will become a limited partner in the arrangement). If a general partnership is used, the general partner should be a separate entity, such as a corporation or an LLC, if possible, to keep the real estate developer’s retirement and family assets protected from claims of creditors.

b. Outside Creditors. If a creditor brings a claim against an owner of an entity (an outside creditor), the creditor can acquire the stock of a corporation from the debtor, but not the underlying assets of the corporation. If the debtor owns an interest in a partnership or an LLC and the creditor is unable to force the partner or member to assign

²⁶ 856 F.3d 267 (3d Cir. 2017); *see also* U.S. v. Rodgers, 461 U.S. 677, 701 (1983).

his or her interest, the outside creditor can obtain a “charging order”. A charging order is neither an assignment nor an attachment. It is a court order that directs the entity to make any distributions to the owner's creditors that it otherwise would have made to the owner. As either an assignee or a holder of a charging order, the outside creditor may be treated as a partner for income tax purposes. The entity can squeeze the creditor by withholding distributions of net cash flow. If no distributions are forthcoming, the creditor would have “phantom income”, and would have to pay income tax on its proportionate share of profits even though no income was actually received.

c. State Statutes. Under most state's Revised Uniform Limited Partnership Acts, a creditor cannot force the sale of a limited partner interest.²⁷ The result is similar in states which have enacted versions of the Re-Revised Uniform Limited Partnership Act.²⁸ In addition, under many limited liability company statutes, a charging order is the only remedy a creditor possesses.

d. Bankruptcy. Since federal bankruptcy law supersedes state law (see discussion of *United States v. Crane*, above), it would be possible to obtain a Federal bankruptcy order to sell an entity interest, regardless of whether it is a general or limited partner interest or an LLC member interest. In no instance, however, could a creditor force the sale of the underlying entity property, unless the claim was secured by such property. Entity agreements typically provide that the other owners and the entity should have the first right to purchase the interest, if it is to be sold due to bankruptcy of another owner.

Under federal bankruptcy law, a bankruptcy trustee may attempt to withdraw from the partnership. Such an attempt should be addressed in the agreement by providing that the withdrawing partner or member (or his or her representative) does not receive fair value until the dissolution of the partnership. This must apply to any partner under any withdrawal in order to be supportable against a creditor.

3. Forms of Entity Ownership

a. Corporation. Generally, an LLC or partnership is the preferred entity of choice for a real estate investor, given that the LLC and partnership structures eliminate the double-taxation of income in the hands of the owner. However, if the entity is an active business with many employees and executives, or has plans for rapid expansion, a corporation may be a better choice. Mortgage and real estate brokerage businesses, hotel operators, and construction companies will often organize as corporations. Corporations are permitted to take advantage of several benefits that are not available to LLCs and partnerships.

(1) Health care premiums are excluded from the gross income of the shareholder-employee under I.R.C. §§ 106(a) and 162(a).

(2) Up to \$50,000 of group term life insurance is excluded from gross income of the shareholder-employee under I.R.C. § 79.

(3) Incentive stock options plans under I.R.C. §§ 421 and 422.

(4) Nonqualified stock options under I.R.C. §§ 83 and 409A.

(5) Employee stock purchase plans (ESOPs) under I.R.C. §§ 421 and 423.

(6) Tax-free reorganizations under I.R.C. §§ 361 and 368 that allow a corporation to (i) acquire stock or assets of another corporation or (ii) adjust its capital structure if all applicable statutory, regulatory and case law requirements are satisfied.

(7) Initial public offering of stock is permitted.

b. S Corporation. An S corporation allows its owners to take advantage of some of the same benefits available to shareholders of C corporations, while still eliminating most problems of double taxation.

²⁷ See, e.g., Md. Code Ann., Corps. & Ass'ns §10-705 (2001); Va. Code Ann., §50-73.46:1 (2006).

²⁸ See, e.g., Idaho Code Ann. §53-2-703 (2006); Fla. State. §620.1703 (2005); Haw. Rev. Stat. §425E-703 (2003).

(1) A shareholder who works in the business as an employee can receive reasonable compensation for services rendered and have employment taxes deducted through payroll rather than reporting self-employment income on Schedule C.²⁹

(2) However, health insurance premiums are included as taxable wages for shareholder-employees owning more than 2% of the outstanding stock,³⁰ offering no real advantage over LLCs.

(3) Incentive stock plans, nonqualified stock options, and employee stock purchase plans are permitted, subject to the one class of stock limitation discussed below.

(4) However, there are the following special rules and limitations with respect to S corporations:

(a) A new corporation must file the S election with the IRS within 65 days after the earliest of the first date on which the corporation has shareholders, acquires assets, or begins doing business.³¹

(b) There can be only one class of stock, although voting and non-voting shares are permitted.³²

(c) There is a limit how many and what type of persons can be shareholders of an S corporation.³³ While up to six generations of a family are allowed to be counted as one shareholder for tax years after December 31, 2004, there can be only 100 unrelated shareholders.

(d) Corporations, nonresident aliens, partnerships and certain types of trusts cannot be shareholders without causing the S corporation to lose its S election.³⁴

c. General Partnerships. A partnership is defined as a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a corporation or trust or estate within the meaning of the Internal Revenue Code.³⁵

(1) *Limited Formalities.* A partnership is created automatically when two or more people come together to engage in business for a profit. It is the only form of business that can be formed by oral agreement. All other types of entities must be registered with a state to be validly created. Thus, a group of persons owning real property as tenants in common can declare themselves to be a partnership simply by filing an IRS Form 1065.

(2) *Management Structure.* Almost all states have adopted the Revised Uniform Partnership Act (RUPA) or the Uniform Partnership Act (UPA) to govern the conduct of the general partnership. The default rules of these uniform laws (which can be varied by a partnership agreement) provide that the partners in a general partnership have equal rights in the management and operation of the business, disagreements are resolved by majority vote, and all the partners have agency power to carry on the business.³⁶

(3) *Liability of General Partner.* Each general partner has joint and several personal liability for all partnership debts, obligations and tortious liability.

d. Limited Partnerships. Limited partnerships are often used in real estate transactions where the equity partner requires the developer to be a general partner. Where a general partner is not required, it is usually preferable to use an LLC instead of a limited partnership or a limited liability partnership, precisely because no owner will have to be exposed to personal liability for the debts and obligations of, and tort claims against, the entity.

²⁹ Rev. Rul. 59-221, 1959-1 C.B. 225.

³⁰ I.R.C. § 162(l)(5).

³¹ I.R.C. § 1362.

³² I.R.C. § 1361(b)(1)(D); Treas. Reg. § 1.1361-1(i)(1).

³³ I.R.C. §§ 1361(b)(1)(A) and 1361(c)(1)(B); Treas. Reg. § 1.1361-1(e)(3).

³⁴ I.R.C. § 1361(b)(1)(B).

³⁵ I.R.C. § 761(a); Treas. Reg. § 301.7701-1(a).

³⁶ See UNIF. PARTNERSHIP ACT § 18; see also REV. UNIF. PARTNERSHIP ACT § 401.

(1) *Formalities.* A limited partnership is a statutory business form. A partnership will not be considered a limited partnership unless a Certificate of Limited Partnership has been filed with the state.

(2) *Management.* Almost all states have adopted either the Uniform Limited Partnership Act of 1976 or the Uniform Limited Partnership Act of 2001 to govern the conduct of limited partnerships. Most of the management of the limited partnership is in the hands of the general partners. Limited partners who participate in the management could lose their limited liability.

(3) *General Partner as Entity.* Where possible, the general partner should be a corporation or an LLC to insulate the individual owner's personal assets from the creditors of the limited partnership.

(4) *General Partners' Basis.* One advantage of being a general partner is the ability to defer taxable income through an increase to the general partner's inside basis. If the general partner is personally liable on a recourse partnership liability, the general partner, but not any limited partner, will include such liability in the basis for his partnership interest under Section 752. The IRS has issued two sets of proposed regulations changing the rules for general partners with respect to "bottom dollar guarantees" and "bad boy carveouts", as discussed in Article II, *infra*.

e. Limited Liability Companies. The LLC is a statutory form of business which generally limits an owner's personal liability to his or her investment. First enacted in Wyoming in 1977, there was for a long time little interest either from business persons or other states because the IRS had stated that such an organization would be taxed as a corporation. However, in 1988, the IRS issued Rev. Rul. 88-76, which classified a Wyoming LLC as a partnership for tax purposes.³⁷

(1) *Taxation of Members.* The members of an LLC can be taxed as a partnership, an S corporation, a sole proprietorship or an association taxable as a corporation, depending on the number of members it has and the elections those members make.

(a) Single Member LLCs. For federal income tax purposes, a single member LLC will be disregarded as an entity separate from its owner unless that member makes an election to be treated as an association taxable as a corporation.³⁸ A disregarded entity's property and activities are treated in the same manner as those of a sole proprietorship—that is, as if they belonged to the owner of the entity. If a single member LLC wishes to be taxed as a corporation, the member must make an affirmative election with the IRS.

(b) Multiple Member LLCs. Under the current "check-the-box" entity classification regime, an LLC with two or more members is treated as a partnership unless the entity elects to be classified as an association taxable as a corporation.

(c) Multi-Party Disregarded LLCs. In some cases, a taxpayer will form an LLC with multiple members, but each member is disregarded for income tax purposes, resulting in a disregarded entity.

i. In Rev. Rul. 2004-77, the IRS concluded that, if an eligible entity has two owners under local law, but one of the owners is, for federal tax purposes, disregarded as an entity separate from the other owner of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation.³⁹

ii. Consider a structure where client forms a single member LLC as the general partner of a limited partnership and also holds the limited partnership interests individually. Under Rev. Rul. 2004-77, this is a disregarded entity for income tax purposes.⁴⁰

iii. The client later gifts or transfers the limited partnership interests to a grantor trust. For income tax purposes, the limited partnership remains a disregarded entity, since the single member LLC and the grantor trust are deemed to be owned by the client/grantor.

³⁷ 1988-2 C.B. 360.

³⁸ Treas. Reg. § 301.7701-2(b)(1)(ii).

³⁹ 2004-2 C.B. 119.

⁴⁰ *Id.*

iv. This structure may be helpful in preserving income tax attributes for the client while facilitating wealth transfer planning opportunities.

(d) An LLC that is treated as a partnership allows its members to avoid the double taxation and higher income tax rates of a corporation while, at the same time, retaining limited liability and other favorable attributes of a corporation.

(2) *Types of Members.* Members of the LLC may be individuals, general partnerships, limited partnerships, other LLCs, corporations, certain trusts (including business trusts), REITs, estates or any other type of association.

(3) *Management.* LLCs may be managed by the members of the company or by individuals or entities designated by the members. The alternative chosen generally must be stated in the articles of organization or certificate of formation. If management is vested in all the members, this power is vested in proportion to their “adjusted” contributions to capital (taking into account a member’s withdrawals and additional contributions). Thus, an advantage of an LLC as compared to a limited partnership is that its members can actively participate in the entity’s management, whereas the limited partners of a limited partnership risk exposure to liability if they become actively involved in the management of the limited partnership.

(4) *Limitation on Liability.* Members and managers of an LLC generally may not be held liable for any judgment, decree or court order, or in any other manner for a debt or liability of the LLC.

(5) *Flexible Structure.* The members of an LLC are given complete freedom to divide the profits of the business on whatever basis is chosen in the operating agreement. Generally, distributions of those profits are made according to the operating agreement, but actual distributions may only be made to the extent assets are in excess of liabilities.

II. REAL ESTATE DEVELOPERS

A. Players in the Deal

To understand many of the planning techniques available to real estate developers, it is important to understand the structure of a typical real estate deal. There are traditionally three parties to a new real estate development project: (i) the developer, (ii) the equity investor or mezzanine lender, and (iii) the construction lender. The developer and the equity investor or mezzanine lender together provide the equity for the project (typically, 20% to 30% of the total dollars needed), and the construction lender provides the rest of the financing.⁴¹

1. Developer

The developer (often called the “sponsor”) is the active partner in the deal. The developer secures the site, designs the project with a third-party or in-house architect, applies for the necessary permits and finds the financing. Because the developer pays for these significant up-front costs (called “pursuit costs”), the developer contributes less to the equity of the project, usually anywhere from 0% to 50% of the equity. An investor will usually want to see the developer contribute at least 5% of the equity to the deal, so that the developer has “skin in the game.”⁴²

2. Equity Investor

The equity investor is a passive investor in the deal. The equity investor is attracted by the opportunity to generate leveraged returns at a level that is rarely available in “buy and hold” real estate transactions. The equity investor will contribute 50% to 100% of the equity needed for the project, but the most typical range is 80% to 95%.⁴³ Some equity investors and developers enter into long term arrangements with one another, while other equity investors will fund “one-off” projects with a developer. Types of equity investors vary widely, but typically include:

⁴¹ For an excellent discussion of the various ways to structure a real estate development project, see Meredith J. Kane, *Equity Investments in Real Estate Development Projects: A Negotiating Guide for Investors and Developers*, THE REAL ESTATE FINANCE JOURNAL (Spring 2001).

⁴² *Financial Structures of Private Equity Investments*, REALTY MOGUL, Sept. 10, 2013, <https://www.realtymogul.com/resource-center/articles/financial-structures-of-private-equity-investments>.

⁴³ *Id.*

a. Private Equity Funds and Opportunity Funds. These investors seek high-risk, high-reward type investments, and usually want the deal to have a quick turnaround, in the range of 3 to 4 years. A developer who cannot afford to put up much of its own equity will often partner with a private equity fund or an opportunity fund. The funds give individual investors the opportunity to access pre-vetted real estate development projects, and the fund managers use their expertise in the industry to identify investment opportunities.

(1) An investor subscribes to the fund as a limited partner and commits to invest a certain amount of capital. The investment horizon for the individual investor in the fund is usually 8 to 10 years.

(2) Over a specified period of time, called the “investment period” or “commitment period”, the general partner will call an investor’s capital and use the capital to purchase real estate projects.

(3) These assets are then owned, repositioned, sold, or held by the limited partnership, depending, of course, on the investment strategy.

(4) Although interests in a real estate opportunity fund are considered a type of security, these interests are generally exempt from registration under the Securities Act of 1933, as amended, by reason of the exemptions provided by section 4(2) of the Securities Act and rule 506 of Regulation D of the Securities Act.

(5) Blackstone claims itself to be the largest real estate private equity firm in the world today, with \$111 billion of assets under management.⁴⁴

(6) Private equity funds may specialize in a particular type of project. For example, the “Senior Living Fund” (www.seniorlivingfund.com) partners with developers of senior living facilities. There are funds that specialize in particular countries as well, such as a fund investing in retail centers in Mexico.

b. Foreign Investors. Foreign investors are attracted to the stability of the real estate market in the United States, the prospect of high returns, and in some cases are motivated by tax savings by investing outside of their home countries.

c. Institutional Endowments. Institutional endowments are typically pension investors and are much more conservative than other types of investors. They will tolerate a longer holding period but require lower risk, so usually will only partner with very experienced developers.

3. Mezzanine Lender

Mezzanine financing is a hybrid of debt and equity financing that gives the lender the rights to convert debt to an equity interest in the developer’s entity in case of default, after venture capital companies and other senior lenders are paid. The mezzanine loan is secured by a pledge of stock or membership interests in the entity that owns the real property. If the developer can fund much of the equity on its own, it may seek a mezzanine lender instead of an equity investor.

4. Construction Lender

Often a developer will have or locate funding to buy the land outright, then use the land as full or partial collateral for the remaining funds needed. Successful developers who have maintained ownership interests in past projects after those projects have been completed can use the other properties as collateral for a construction loan for a new project. Some of the most common types of construction loans are as follows:

a. Land Development Loan. When raw or undeveloped land needs to be made construction-ready, a land development loan can be obtained. The raw land may be subdivided and sold as multiple parcels for commercial or residential use. It may also include the installation of sewer, water or power lines to the site.

b. Acquisition and Development Loan. An Acquisition and Development (“A&D”) loan is used when raw land is ready to be developed, or is already developed but needs improvements to its infrastructure or existing buildings. The A&D loan usually covers both the purchase of the land and the cost of improvements needed before the development can be completed.

⁴⁴ <https://www.blackstone.com/the-firm/asset-management/real-estate>.

c. Mini Perm Loan. A mini perm loan is a temporary loan typically used to settle an outstanding construction or commercial property loan on a project that, once completed, would produce income. After 3 to 5 years of generating income, the mini perm loan is replaced with long-term financing. Mini perm loans are normally obtained through commercial banks.

d. Interim Construction Loan. An interim construction loan pays for the labor and materials used to construct a project. This type of loan is usually valid for 18 to 36 months, and is settled once a long-term mortgage (a “takeout loan”) is in place.

e. Takeout Loan. A takeout loan is a loan that replaces another loan. It provides permanent financing on projects where a temporary loan, such as a short-term construction loan, currently exists. Many construction lenders require their developers to secure the takeout financing before they will grant the short-term construction loan.

B. Legal Structure of the Deal

There are several possible legal structures in which the equity parties can be organized, but most real estate investments are structured using LLCs wherever possible so that none of the participants -- neither the equity investor nor the developer -- will (generally) be financially liable for the project beyond the value of their investment. The structuring issues then come down to questions of how to divide the financial benefits of the project among the equity parties. The operating agreement or partnership agreement will usually address the following economic terms of the deal:

1. Equity Pay-In

An equity investor will often wait to commit to fund a deal until the project construction loan is closed, which means all project land and development rights must have already been secured; construction financing has been committed; building permits, zoning and other entitlements are in place; tax abatements have been granted; environmental reviews have been completed; and, if the project is to be pre-leased or pre-sold, the applicable leasing and sale thresholds have been met. The developer must spend a great deal of time and money to accomplish all of this.

An equity investor can agree to refund the developer’s pursuit costs. If so, the developer must negotiate with the construction lender to ensure the terms of the loan allow the investor’s equity to be used partially to reimburse the developer.

2. Preferred Return

The preferred return is paid to all equity parties, both the developer and the equity investor, and is usually a 5% to 10% return after all invested capital has been recovered. Often, the lender will require that the preferred return cannot be paid out until the project is completed, even if revenue is being generated during the construction process through pre-leasing and presales.

3. Cash Flow and Profits

The equity investor usually receives 50% to 80% of the remaining cash flow and profits once they have received a return of their capital plus the preferred return.

4. Developer Promotes

The developer can receive a “promote” share of the remaining cash flow and profits. Here is an example of a distribution waterfall which illustrates the division of distributions and profits between the developer and the equity investors, assuming the developer contributed 10% of the capital and the equity investors contributed 90% of the capital.⁴⁵

a. **First, 100% pro rata to the Members until each member has received an amount equal to a 10% internal rate of return (“IRR”) preferred return and its unrecovered capital contribution.** Since the sponsor has contributed 10% of total equity alongside his co-investors, this first tier of the waterfall splits revenues on a proportionate basis until everyone has received a full return of capital plus a 10% annualized compounded rate of return. This first tier is the preferred return.

⁴⁵ See, Ian Formigle, *What is a Real Estate Sponsor Promote?*, CROWDSTREET, Apr. 1, 2016 <https://www.crowdstreet.com/education/article/what-sponsor-promote/>.

b. **Second, 75% to the Members until each member has received an amount equal to a 20% IRR, and 25% to the developer as Promoted Interest.** This is the first tier of the promote. Above a 10% IRR, the developer now earns 25% of all excess profits over and above the developer's pro-rata share of his own profits from his 10% equity contribution. This disproportionate profit split continues until all the Members receive a 20% IRR. Another way to look at this second tier is on a pure investors vs. developer split basis. Since equity investors contributed 90% of total equity, then at the second tier, they receive 75% of 90% or 67.5% of excess profits above a 10% IRR up to a 20% IRR. The developer receives the balance or 32.5% of excess profits above a 10% IRR up to a 20% IRR, which is inclusive of his 10% equity contribution.

c. **Thereafter, any remaining net cash shall be distributed 60% to the Members and 40% to the developer as Promoted Interest.** This is the second and final tier of the promote. Above a 20% IRR to all equity parties, the developer now earns 40% of all excess profits. When looking at it from the pure investors vs. developer split perspective, this would mean that investors receive 60% of 90% or 54% of profits above a 20% IRR and the developer receives 46% of excess profits above a 20% IRR, which is inclusive of his 10% equity contribution.

5. Development Fees

The developer may receive agreed-upon fees for its work acquiring the property, obtaining financing and managing the project. Development fees and management fees are compensation and are taxed as ordinary income. Possible types of fees include development fees, management and leasing fees, sale and marketing fees, construction supervision fees, project acquisition fees and many others. The equity investor, the construction lender and the developer will negotiate the timing of the fee payment, and whether and which fees are guaranteed versus contingent.

a. **Bona Fide Fees.** These fees represent the actual costs of overhead, personnel and project supervision incurred by the developer in managing the project. They are often paid to the developer during the development period.

b. **Profits Portion of Fee.** Any fees that exceed the developer's costs in project administration, which represent the profits portion of the fee, are usually paid upon the attainment of certain performance hurdles, such as groundbreaking, percentage completion of construction, and completion of construction. Such fees could also be paid once a certain percentage of sales, pre-leases or leases are in place, or a target average sales price or rental rate has been achieved. The lender will push to defer the fees as much as possible, but one example of a fee structure might be 25% of the fee recognized at loan closing, 50% paid over the course of draws on loan for hard costs, and the final 25% once the project has stabilized or has received a certificate of occupancy.

c. **Developer's Fee.** A developer's fee is the most common fee awarded to the developer, and it is usually based on a percentage of the total project costs, ranging from 3% to 5% of all soft costs (such as marketing), hard costs (such as materials) and land costs.

d. **Acquisition Fee.** The developer may also be paid an acquisition fee of around 1% of the total project cost for putting the deal together.

6. Tax Benefits

Equity investors usually receive the bulk of the tax benefits, such as depreciation and interest deductions.

7. Exit Strategies

A development project "stabilizes" once the project is fully constructed, 90% to 95% leased, and has been operating at pro forma economics for several consecutive months. Upon stabilization, the construction financing can be taken out (hence, the name "takeout loans") and replaced with permanent financing based on stabilized net operating income and updated loan to value ratios.

The goal of the developer is that, once the permanent financing is in place, the equity investor will be fully bought out of the deal. This way, the developer gets to keep all of the rental income from the property going forward. If the financing cannot be found to buy out the equity investor, the developer may need to put the entire project up for sale.

If the equity investor is only partially bought out, it will be important for the developer to ensure that the operating agreement or partnership agreement contains buy-sell and right of first refusal provisions to allow the equity investor to cash out at some future point while allowing the developer to maintain ownership of the project.

C. Developer's Risk and Tax Treatment

Both the construction lender and the equity investor may seek various personal guaranties from the developer. The lender may require the following: (i) completion guaranty, (ii) guaranty of non-recourse carve-outs, (iii) environmental indemnity, (iv) full or partial loan repayment guaranties. The equity investor will generally look to the developer to provide (a) personal guaranties to the lender, without resort to the credit of the equity investor, (b) completion guaranties, and (c) cost overrun guaranties. The developer's personal guaranties are discussed in greater detail below, along with a high-level discussion of the income tax consequences to the developer and the entity.

A note on grammar: the word "guarantee" is acceptable in all contexts, and covers all promises that something will be performed in a certain matter or an item will fulfill certain expectations. A "guarantee" is usually a formal, written pledge that an item purchased is in good working order and will remain so for a certain period of time, or that a service rendered was done in a professional, competent manner that assures a specific outcome. The word "guarantee" may also be used as a verb to mean the act of making such a promise. Meanwhile, the word "guaranty" is obsolete in all but financial and legal contexts, and is now used as a noun to refer to something that is offered as security that an action will occur.⁴⁶ "Guaranties" is the plural form of a guaranty. The use of the word "guaranty" is appropriate as a noun in the real estate context for the financial promises that a developer makes to a lender as security for a loan.

1. Types of Liability

Before understanding the personal liability of the developer in a real estate deal, it is important to understand the treatment of debt incurred by a partnership or LLC in general. There are three types of liabilities in the partnership context: nonrecourse, qualified nonrecourse and recourse. These liabilities are factored in to the calculation of a partner's basis, both for making tax-free distributions and also for deducting partnership losses. Section 752 covers the treatment of liabilities for a partnership, while Section 465 deals with limitations on deducting losses (called the "at risk" rules).

a. Recourse Liabilities. A liability is considered recourse if any partner bears the economic risk of loss with respect to the liability, which would arise if a partner or any person related to a partner would be obligated to make a payment to the creditor upon a constructive liquidation of the partnership under certain circumstances. Recourse liabilities are allocated on a proportionate basis to the capital accounts of partners that have this personal liability, which can provide increased basis that in turn can shelter the partner's distributions from income tax.⁴⁷ Recourse liabilities can also provide the liable partner with basis to deduct losses under Section 465.

(1) *Economic Risk of Loss.* A partner is considered to bear the economic risk of loss for a partnership liability to the extent that the partner or a related person would be obligated to make either (i) a payment to any person or (ii) a contribution with respect to such liability, if in either case the partnership constructively liquidated at that time and there were no entitlements to any reimbursement from another partner or person related to another partner.⁴⁸

(2) *At Risk Rules.* For individuals, trusts, estates, and closely-held C corporations, deductions of losses from business or investment related activity for a tax year are limited to the amount the taxpayer is at risk. The amount at risk includes (i) the amount of money and the adjusted basis of property contributed to an activity, (ii) amounts borrowed with respect to the activity to the extent the taxpayer is personally liable for repayment or has pledged his or her own property (owned outside of the partnership) as security, and (iii) amounts of qualified nonrecourse financing (which is a topic beyond the scope of this outline). The amount at risk is also increased by the excess of income from an activity for the tax year over items of deduction from the activity for the tax year (essentially, profits increase the amount at risk).

b. Nonrecourse Liabilities. A liability is generally considered nonrecourse if no partner bears the economic risk of loss with respect to the liability. Nonrecourse liabilities are typically those loans that are secured only by assets of the partnership. Only the creditor bears the economic risk of loss with respect to a nonrecourse liability.

⁴⁶ *Guarantee vs Guaranty*, GRAMMARIST, <http://grammarist.com/usage/guarantee-vs-guaranty/>.

⁴⁷ Treas. Reg. § 1.752-2(a).

⁴⁸ Treas. Reg. § 1.752-2(b).

Nonrecourse liabilities are allocated among all the partners and can provide basis for distributions under Section 752, but generally not for the deduction of losses under Section 465.

2. Guarantees

Where a developer is a general partner in a project, his guaranties create recourse liabilities that can be used to defer income.

a. In General. Guaranties often result in an allocation of the guaranteed debt to the capital account of the partner-guarantor.

b. First Dollar Guarantees. The lender can seek payment of the guaranteed amount to the full extent of its failure to collect from the partnership. If the lender collects up to or more than the guaranteed amount from the partnership, then the guaranty is extinguished.

c. Vertical Slice Guarantees. A partner guarantees only a portion of each dollar of the partnership liability.

d. Bottom Guarantees. Common in real estate lending transactions, the bottom-dollar guarantee obligates a partner-guarantor to make a payment to a lender if the lender fails to collect a specified minimum amount from the partnership or LLC.

(1) For example, a partner may guarantee \$250,000 of a \$1 million partnership liability, which may be secured by \$1.5 million of assets. This means, the guaranty would only be called by the lender to the extent the lender failed to collect at least \$250,000 from the partnership or LLC in the case of default on the loan. If the lender collects \$275,000 from the partnership, the partner-guarantor has no liability under the guaranty, and if the lender collected only \$200,000 from the partnership, the partner-guarantor is liable only for \$50,000.

(2) Under prior law, real estate developers might include economically meaningless bottom guaranties in a loan structure simply to get the allocation of the recourse liability to the partner's capital account. In the example above, the partner-guarantor could have allocated the \$250,000 of guaranteed recourse liability as well as his portion of the remaining \$750,000 nonrecourse liability under the rules for allocations of liabilities under Section 752.

e. New Regulations Reduce Benefits. Treasury published proposed regulations to alter the rules relating to Section 752 in 2014. On December 27, 2016, the IRS withdrew those proposed regulations in response to the comments it received, and issued new proposed regulations in its place.⁴⁹ The Proposed Regulations prevent "bottom-dollar" guaranties from being recognized for purposes of Section 752 by providing that, in the case of guaranties, an obligation of a partner or related person is recognized only if the partner or related person is liable for up to the full amount of the payment obligation.⁵⁰

f. Anti-Abuse Rules. Further, to prevent partners (or related persons) from attempting to use structures or arrangements to circumvent the rules, the Proposed Regulations revise the anti-abuse rule under Treas. Reg. § 1.752-2G to address the use of intermediaries, tiered partnerships or similar arrangements to avoid the bottom-dollar guaranties.

3. Bad Boy Carveouts

a. In general. When the developer makes personal guaranties to the lender, the developer and equity investor typically agree to contribute pro rata to the payments if any of the guaranty payments are called by the lender, except in where the payments are called due to the misconduct of the developer or actions of the developer for which it is liable to the equity investor. Alternatively, the lender may issue nonrecourse financing to the partnership, but require a "nonrecourse carve-out" guaranty from the developer, which guaranty would be triggered upon the occurrence of certain acts, such as the filing of a voluntary bankruptcy petition. These exceptions are referred to as "bad boy carve-outs". In practice, the "bad boy" exceptions rarely occur, as the acts are in control of the developer.

b. CCA 201606027 (Reversed). In this Chief Counsel Advice memorandum, issued in early 2016, the IRS determined that a bad boy guarantee caused an otherwise nonrecourse debt to be treated as recourse with

⁴⁹ I.R.B. 2016-52.

⁵⁰ Prop. Treas. Reg. § 1.752-2(b)(3).

respect to the guaranteeing partner for purposes of applying the partnership basis allocation rules and the at-risk rules. The IRS's position was widely criticized by tax and real estate professionals. The characterization of nonrecourse debt that is subject to a customary bad boy guarantee as recourse financing would have shifted debt-related basis and deductions away from the non-guaranteeing partners in favor of the guaranteeing partner, which is contrary to how real estate partnerships have generally allocated basis and deductions.

c. GLAM 2016001. In April of 2016, to the relief of many in the real estate community, the IRS issued this generic legal advice memo, in which it concluded that a partner's guarantee of a partnership's nonrecourse obligation that was contingent on the occurrence of nonrecourse carve-out events will not prevent the obligation from qualifying as a nonrecourse liability under Section 752 or qualified nonrecourse financing under Section 465(b)(6), unless and until such "bad boy" carve-out event occurs. This reverses the position taken by the IRS in CCA 201606027.

III. INVESTORS, DEALERS, AND VACATIONERS

A. Investor versus Dealer

A dealer of real estate is usually subject to ordinary income tax treatment upon the sale of real property; whereas an investor in real estate usually pays capital gains tax on the sale of real property. Considering the gap between long-term capital gain tax rates and the highest ordinary income tax rates, the distinction between dealer status and investor status is an important one. It may be beneficial to achieve dealer status if a taxpayer has net operating losses, but most taxpayers prefer investor status and the accompanying lower tax rate. Over the years, the courts have developed a facts and circumstances test for determining dealer versus investor status. By properly structuring real estate transactions and knowing which facts to highlight in the client's records and books, clients can build a case for dealer or investor status to achieve the desired tax treatment.

1. Statutory Framework

a. Capital Gain Treatment. Section 1201(a) provides for preferential treatment with respect to gain realized on the sale of a capital asset.

b. Capital Asset. Section 1221(a)(1) defines a capital asset as "property held by the taxpayer but does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business".

c. Dealer. Thus, a "dealer" in real estate is someone who holds land for sale in the ordinary course of his trade or business, and capital gains treatment does not apply to the sale.

d. Primarily for Sale in Business. The term "primarily" for purposes of Section 1221 means "of first importance" or "principally".⁵¹ Whether a taxpayer held specified property primarily for sale to customers in the ordinary course of business is a question of fact.⁵²

2. Facts and Circumstances Test

The Tax Court and the Court of Appeals for the Ninth Circuit have identified five factors for evaluating whether a taxpayer held certain properties primarily for sale to customers in the ordinary course of business.⁵³

- Analyze the nature of the acquisition of the property. Was the land initially purchased for investment or development? At that time, was the taxpayer's primary service or occupation and/or principal product real estate?
- Assess the frequency and continuity of the taxpayer's property sales over an extended period. Is the taxpayer often involved in land sales, indicating that the land is more like inventory than an investment?
- Consider the nature and extent of the taxpayer's business. Were the taxpayer's actions to increase the land's value more like those of a developer or an investor?

⁵¹ See *Malat v. Riddell*, 383 U.S. 569 (1966).

⁵² *Austin v. Comm'r*, 263 F.2d 460, 461 (9th Cir. 1959), *rev'g* T.C. Memo. 1958-71.

⁵³ *Id.* at 462.

- Examine the level of activity of the seller with respect to the property. Did the taxpayer work to improve, re-zone, add sewer and water, or spend a significant amount of time finding buyers and negotiating property sales?
- Evaluate the extent and substantiality of the sale transaction. Were there any red flags indicating that (i) the sale may not have been at arm's length or (ii) the price may not have been at market value?

As the court stated in *Austin v. Comm'r*, “in the final analysis, however, each case must be decided upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case.”⁵⁴ It is rare indeed that one will find any precedent value in applying the decision of one case to the facts of another case. At the most, other cases decided by the courts on this subject may be persuasive or suggestive of the approach of the courts to cases where the facts may be somewhat similar.”⁵⁵ These factors have been applied in cases over the years.

a. Austin v. Commissioner. In *Austin*, the Ninth Circuit developed the framework for the facts and circumstances test.⁵⁶ In this case, the taxpayer was a lawyer who had been continuously engaged in the practice of law. Sometimes he received lots in his town of Manhattan Beach, California, as payment for legal services, sometimes clients asked him to buy their property, sometimes he bought vacant lots to protect the character of his neighborhood, and other times the city asked the taxpayer to buy lots from the government so that the lots could be brought onto the city’s tax rolls. All of the lots were unimproved. In some instances, the government sold the lots for the taxpayer’s failure to pay real property taxes, and sometimes the taxpayer sold the lots after holding them from three to eight years. The Commissioner maintained and the Tax Court found that the lots were held primarily for sale to customers in the ordinary course of the taxpayer’s business. The Ninth Circuit reversed and held that the whole record showed the taxpayer was not primarily engaged in the business of selling real estate and was therefore entitled to capital gains treatment.

b. Applying the Factors. In a recent case, *Pool v. Comm'r*, T.C. Memo. 2014-3, the Tax Court considered each of the five factors in ruling that the taxpayers improperly reported ordinary partnership income as capital gain.⁵⁷ The case involved an LLC, Concinnity LLC, which purchased 300 acres of undeveloped land divided into four sections. Three of the sections were part of an exclusive rights agreement with a development company, and the LLC eventually sold these sections to the development company in two installment sales. On Concinnity's 2005 return, the LLC reported the taxable portion of the payments received in 2005 from these sales as a long-term capital gain. The IRS audited the partnership and disallowed capital gain treatment, concluding that Concinnity was a dealer in real estate.

The Tax Court examined the five factors and came to the following conclusions: (1) Concinnity purchased the land to divide and sell to customers; (2) Concinnity failed to prove that its sales of land were not frequent enough to be considered to be in the ordinary course of business; (3) Concinnity took more of a developer's role than an investor's role because the company improved the land with water and wastewater systems, found additional investors, and brokered the land sale deals; (4) there was little proof that Concinnity did not actively seek out buyers for individual lots before it sold the three sections of land to the development company; and (5) the sale to the development company was at a price well above market value and thus was not at arm's length. As a result of these findings, the Tax Court denied Concinnity's partners' capital gain treatment on the sale of the property.

c. Intent Can Be Determinative. In *Allen v. U.S.*, the U.S. District Court for the Northern District of California determined that three of the five factors in the case proved the property sale in question was more similar to a sale to a customer in the ordinary course of business than to a sale of a capital asset on account of the taxpayer’s intent in purchasing the real estate.⁵⁸ In *Allen*, the taxpayers, a husband and wife, purchased several acres of land to develop and sell in East Palo Alto, California. After attempting to develop the property themselves, which included hiring engineers for planning purposes, the Allens changed their focus and instead tried to find investors to develop and sell the property. More than a decade later, the property was sold to a real estate development corporation under an installment sale arrangement, which the taxpayers reported as capital gain.

The IRS denied the long-term capital gain treatment, arguing that the Allens held the property for resale and not as investment property. The court sided with the IRS. It found that the first and fourth factors were determinative, stating that Allen held the property for resale because “the evidence is compelling that Fredric Allen intended to develop the property when he purchased it and that he undertook substantial efforts to develop it during the time

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ T.C. Memo. 2014-3.

⁵⁸ 113 A.F.T.R. 2d 2014-2262 (D.C. CA 2014).

that he owned it.” The court also considered the other factors, but found that the support they gave for the Allens’ position was not strong enough to change its conclusion based on the first and fourth factors.

d. Motives of Other Owners Not Imputed to Taxpayer. In *Rosewood v. U.S.*, the taxpayer was in college when her parents created an irrevocable trust for her benefit.⁵⁹ The taxpayer’s father had acquired an option to purchase approximately 1160 acres of San Francisco peninsula land. The taxpayer’s trust entered into a tenancy-in-common arrangement with several other investors and made the purchase. The trust, which owned a 1% tenant in common interest in the land, was dissolved later that year and the interest was transferred to the taxpayer. The taxpayer’s father convinced her to sell her 1% interest to the other investors, and she did. The Ninth Circuit held that even though the other real estate investors may have had the intent to sell the property in the ordinary course of their business, the taxpayer did not, and she was permitted capital gains treatment on the sale.

e. Dealers Can Hold Investment Property. In *Harbour Properties, Inc. v. Comm’r*, the Tax Court confirmed that even dealers can hold investment property.⁶⁰ Here, the taxpayer was in the real estate business and purchased a property that he did not consider ready for development. He decided to hold the property for investment until the market was ready for the parcel. Importantly, the taxpayer listed the parcel on his balance sheet under the category “Investments”. The property was unimproved, held by the taxpayer for 5 years and was not offered for sale during that time. The Tax Court held the sale qualified for capital gains treatment as an investment.⁶¹

3. Planning Opportunities

Because courts will generally use the five-factor test, clients can plan how they structure, undertake, and account for a land sale to increase the chance that a court will hold that it was a sale of investment property rather than a sale of property held primarily for sale to customers in the ordinary course of a trade or business. Based on these factors, taxpayers can take the following steps to avoid this result:

a. Segregate Property. If the client is already a dealer in real estate by occupation and the client purchases a property with the intent to hold it as an investment and not as part of the active business, the client should segregate that property on the client’s books and records. If the property is listed on the books from inception as an investment, this will evidence the taxpayer’s intent and increase the chance of capital gain treatment when the taxpayer sells the investment property.

b. Report Items as Investment Expense. Deductions related to a piece of property, such as interest expense, should be reported as investment expenses rather than business expenses.

c. Governing Documents. If an LLC is used to acquire the property, the LLC operating agreement should state that its purpose is to hold the property as an investment. If a corporation is used to acquire the property, the meeting minutes of the entity should also express this intent.

d. Using Separate Entities. One factor that determines a seller's intent is the frequency of sales. To avoid dealer status, it may be advantageous to hold investment property in a separate legal entity with a different ownership structure.

e. Show Time Spent on Other Activities. Taxpayers who can show that the time spent with respect to the investment property was insignificant when compared with the time spent in their everyday occupation may be able to achieve investor status.

B. Vacationer versus Landlord

When a client purchases a vacation property, they may intend to rent the property when they are not using it to help offset the mortgage and other expenses. Whether the client must report rental income, and whether the client can deduct all of the expenses of the property as rental expenses depends both on how frequently the client uses the property and how frequently the property is rented.

⁵⁹ 317 F.2d 362 (9th Cir. 1963).

⁶⁰ T.C. Memo. 1973-134.

⁶¹ See also *Tibbals v. U.S.*, 362 F.2d 266 (Ct. Cl. 1966).

1. Income

Under Section 280A(g), if the client rents the property out for two weeks or less in a given year, the taxpayer is not taxed on the rental income (but also cannot deduct any rental expenses).

2. Deductions

a. General Rule. A taxpayer who owns a vacation home for personal use and enjoyment is entitled to the same deductions for mortgage interest, real property taxes and casualty losses that the taxpayer is entitled to with respect to her personal residence.⁶²

b. 14 Day or 10% Rule. Section 280A(d)(1) provides that a home is considered to be used as a residence in any tax year in which the owner's use of the property (or a portion of it) for personal use exceeds the longer of (i) 14 days or (ii) 10% of the period of rental use.

(1) For example, if the property is rented for 12 weeks each year during the summer season, and the client uses the property for exactly two weeks in a year, the property will not be considered a personal residence for that year. Even though the taxpayer has used the property for 16.67% of period of rental use, the taxpayer's use has not exceeded 14 days, and the test is the longer of these two periods.

(2) Use by members of the owner's family is imputed to the owner.⁶³

(3) In addition, if any individual uses the property without paying fair market rent, that individual's use counts as use by the owner.⁶⁴

c. Rental Property. If the dwelling unit is not considered to be a residence of the client because the Section 280A(d)(1) test has been met, the property is considered an investment or rental property. In that case, all of the rental expenses of the property are deductible. This includes insurance, utilities, housekeeping, and repairs in addition to the mortgage interest and property taxes. Even the cost of towels and sheets is deductible on Schedule E. The client can also take a depreciation deduction.

(1) Time spent checking in on the house or making repairs doesn't count as personal use.

(2) The client can rent the property to a family member and have that count as a rental day despite Section 280A(d)(2)(A), but only if the family member pays fair rent.⁶⁵

d. Small Landlord Exception to Passive Activity Loss Rules. There is an exception to the passive activity loss rules discussed in the next Article for individual owners renting dwelling units. If the client and his spouse actively participate in the rental of a real estate, he may be able to deduct up to \$25,000 of loss from the rental activity from his non-passive income.⁶⁶ The exemption is phased out for taxpayers with adjusted gross incomes in excess of \$100,000.

(1) Active involvement in the rental activity includes approving new tenants, and coming up with rental terms.

(2) The client should keep detailed records of time spent managing the rental and maintain a separate checking account.

(3) In order to qualify for this exception, the client must own at least 10% of the property.⁶⁷

⁶² I.R.C. §280A(b).

⁶³ I.R.C. § 280A(d)(2)(A).

⁶⁴ I.R.C. § 280A(d)(2)(C).

⁶⁵ I.R.C. § 280A(d)(3).

⁶⁶ I.R.C. § 469(i).

⁶⁷ I.R.C. § 469(i)(6).

e. Mixed Use Property. If the client has a vacation home that he and his family personally use for more than the greater of 14 days or 10% of the rental days, but the property is still rented for a significant portion of the year, the client is still entitled to deductions for rental expenses. The deductions are simply limited to the ratio of time the house was rented compared with the total days the house was used.⁶⁸

IV. PASSIVE VERSUS ACTIVE INCOME

As discussed in Article III, current tax law provides that if profits received from a real estate investment are attributable to operating income or active investment, such profits are of an ordinary nature and are taxed as ordinary income. If the profits received by a real estate investor are of a capital nature, such as gains from the sale of an appreciated investment property, they are taxed as capital gains.

If the property generates losses instead of income, losses from an active investment are deductible, whereas losses from a passive activity are typically disallowed.

A. Passive Activity Losses

In order to prevent perceived abuses arising out of certain investment activities engaged in by taxpayers, Congress enacted Section 469 to stop taxpayers from offsetting the losses of one activity against the profits of another. Congress was especially concerned when those losses were earned in activities in which the taxpayer had limited or no participation. Section 469 was enacted to combat this abuse by disallowing any losses to a taxpayer which are earned from “passive activities.” The losses arising from such activities are known as passive activity losses (“PAL” or “PALs”).

1. Statutory Framework

Section 469(a)(1) provides that a taxpayer’s passive activity loss is disallowed for the year if the taxpayer is “described” in Section 469(a)(2). Taxpayers “described” in Section 469(a)(2) are individuals, estates, trusts, closely-held C corporations, and personal service corporations.

a. Passive Activity Loss. A “passive activity loss” is the amount by which the aggregate losses from all of a taxpayer’s passive activities during the year exceed the aggregate income from all of a taxpayer’s passive activities during the year.⁶⁹

b. Passive Activity. A “passive activity” is any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.⁷⁰

c. Rental Activity. Under Section 469(c)(2), any rental activity is considered a passive activity, even if the taxpayer materially participates.⁷¹ So, rental activity is passive *per se*.

2. Exception for Real Estate Rental Activity.

In 1993, Congress enacted Section 469(c)(7)⁷², which provides that the “passive *per se*” rule applicable to rental real estate activity does not apply if the taxpayer meets certain requirements set forth in Section 469(c)(7)(B).

a. Test for Active Real Estate Rental. Section 469(c)(7)(B) sets out two tests. If both requirements are met, the taxpayer may treat rental real estate activity as active and not passive and thus deduct losses:

(1) First, more than one-half of the personal services performed by the taxpayer in trades or businesses during the year is performed in real property trades or businesses in which the taxpayer materially participates; and

(2) Second, the taxpayer must perform more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

⁶⁸ I.R.C. § 280A(e)(1).

⁶⁹ I.R.C. § 469(d)(1).

⁷⁰ I.R.C. § 469(c)(1).

⁷¹ I.R.C. § 469(c)(4).

⁷² Omnibus Budget Reconciliation Act of 1993, Pub. Law No. 103-66.

b. Test for Corporations. Section 469(c)(7)(D)(i) provides a test for determining whether a closely-held C corporation can be excepted out from the “passive *per se*” rule for rental real-estate activity. This test does not require the C corporation to meet the 750 hours and more than one-half of personal services test required of other taxpayers; rather, a closely-held C corporation need only show that 50% of its gross receipts for the taxable year were derived from real property trades or businesses in which the corporation materially participates.

Note, although individuals and closely held C-corporations are the only types of persons provided for in the statute, the exemption for active rental real estate activity has been extended by the Tax Court to trusts owning rental real estate and the efforts of trustees performing services on behalf of the trust.⁷³ Trusts owning rental real estate are discussed in Article VII.B, *infra*.

c. Personal Services. “Personal Services” means any work performed by an individual in connection with a trade or business. Treas. Reg. 1.469-9(b)(4).

d. Real Property Trade or Business. “Real property trade or business” is defined in Section 469(c)(7)(C) as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.

e. Material Participation. “Material Participation” is defined in Section 469(h) as involved in the operation of the activity on a basis that is regular, continuous and substantial.

In summary, a taxpayer defaults to the general Section 469 rule that rental activity is passive *per se*. The taxpayer must review his participation in each activity to determine whether he materially participated. Therefore, in order to determine whether a taxpayer engaging in the rental of real estate is qualified to use the losses arising therefrom, a multistep, albeit somewhat circuitous, analysis must be undertaken.

B. Qualifying as a Real Estate Operator

Taking the statutory rules as a whole, in order for an individual to qualify as a “real estate operator”, the individual must work in a real property trade or business on a regular, continuous and substantial basis, for more than half of all their working hours for the year, and for more than 750 hours a year.

1. Personal Service Hours

a. Services as Employee. For purposes of determining whether the more than half and more than 750 hours of work requirements are met, an individual’s work hours include personal services performed in the capacity as an employee, but only if the employee is a 5% owner of the employer.⁷⁴ That is, the hours spent as an employee will count towards the denominator of the fraction used for the first test, but not the numerator unless the employee owns 5% of the employer. Neither the Internal Revenue Code nor the underlying regulations specify whether this rule applies to an independent contractor.

b. Services Performed in Investor Role. In determining which hours qualify as personal services, the regulations specifically exempt from the definition of personal services any work performed by an individual in his capacity as an investor.⁷⁵ That is, such services will be counted neither towards the numerator nor the denominator of the first test. The regulations provide that the following will be considered performed by an individual in their capacity as an investor:

(1) Studying and reviewing financial statements or reports on the operations of the activity.

(2) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual’s own use.

⁷³ See *Frank Aragona Trust v. Comm’r*, 142 T.C. 165 (2014); cf. CCA 201244017 (Nov. 2, 2012).

⁷⁴ I.R.C. § 469(c)(7)(D)(ii); Treas. Reg. § 1.469-9(c)(5) (stating that if the individual is not a 5% owner during all times of the taxable year, only the period during which the employee is a 5% owner will be treated as performed in a real property trade or business).

⁷⁵ Treas. Reg. § 1.469-9(b)(4).

capacity.⁷⁶ (3) Monitoring the finances or operations of the activity in a non-managerial

Such work will not be treated as participation activities unless the individual is directly involved in the day-to-day management or operations of the activity.⁷⁷ This definition of investor hours is used in determining not only whether the time spent is personal services, but also whether the hours count towards the material participation test.

c. Permissible Personal Service Activities. The Tax Court has indicated that making repairs, completing administrative tasks such as paying bills and recordkeeping, communicating with tenants, researching landlord/tenant law, preparing tax returns, and other management activities can be considered appropriate activities.⁷⁸ Furthermore, marketing, promoting, and networking for purposes of soliciting clients or additional capital can be considered as performed in day-to-day management or operations when they are an integral part of the business.⁷⁹ Additionally, activities related to participating on the board of a condominium association and dealing with issues related to employee housing, quality assurance, a fire protection system, a proposal by the surrounding town to terminate its ownership of the real property and management compensation can be considered as completed in the capacity as a manager rather than investor.⁸⁰

d. When Activities are Not Included. Where the taxpayer performs services in a “hands off” manner and merely as an investor, the Court has found that the activities do not count towards participation.⁸¹ Courts have found that cleaning an office, shoveling snow, and dealing with the aftermath of burglaries including investigating, repairing damages and appearing at city hall to offer testimony do not qualify as personal services completed in a trade or business where the taxpayer is not in the business of providing such services and appears to provide them free of charge to assist his spouse in her business operations.⁸² Nor will time spent “on call” be included when no actual services were provided.⁸³

e. Facts and Circumstances Test. The regulations offer little guidance on how to define the scope and grouping of activities for purposes of determining what lines of business should be included as a real property trade or business. The analysis is made using a reasonable analysis of the facts and circumstances and the taxpayer is not required to use the rules applicable to other activities falling under Section 469.⁸⁴ However, the taxpayer is required to be consistent from year to year.⁸⁵

2. Aggregation of Activities

Second, the taxpayer must decide what activities he participates in and how they should be aggregated for purposes of determining whether he materially participates in them. Section 469 is applied as if each interest of the qualified taxpayer in the rental of real estate is a separate activity. However, the taxpayer may elect to treat all of his interests as a single activity,⁸⁶ but he may not group a rental real estate activity with other real estate activities such as development or constructions of real property.⁸⁷ Therefore, it is possible that a taxpayer’s groupings could be different for purposes of determining whether he is

⁷⁶ Treas. Reg. § 1.469-5T(f)(2)(ii)(B).

⁷⁷ Treas. Reg. § 1.469-5T(f)(2)(ii)(A).

⁷⁸ Hassanipour v. Comm’r, T.C. Memo. 2013-88 (suggesting, however, that appropriate personal service activities will only be counted if taxpayer has reliable contemporaneous data and other “indicia of unreliability” when attempting to prove the number of hours spent on such activities in relation to other work).

⁷⁹ See, e.g., Tolin v. Comm’r, T.C. Memo. 2014-65 (finding that marketing and promoting were integral to the horse breeding business); Lamas v. Comm’r, T.C. Memo. 2015-59 (finding that marketing and promotion were integral to the real estate business).

⁸⁰ Mordkin v. Comm’r, T.C. Memo. 1996-187.

⁸¹ See Toups v. Comm’r, T.C. Memo. 1993-359 (finding the following activities were provided by the taxpayer as an investor: (1) providing funds for the purchase of owned property unit; (2) preparing an annual budget with respect to the property; (3) preparing a cash flow analysis; (4) providing a rental agency for the rental of taxpayer’s unit under the pooling arrangement with other property owners; (5) marketing the property and rental of taxpayer’s unit; (6) meeting with the other unit owners; (7) establishing rental rates for the units with the other owners; (8) inspecting the unit and common areas at least twice a year; (9) reviewing monthly reports received from the rental agent; (10) reviewing other correspondence from the rental agent; (11) reviewing advertising brochures about the property received from the rental agent; (12) receiving and depositing net revenues received from the rental of the unit; and (13) issuing checks for pooled expenses of the units).

⁸² See DeGuzman v. U.S., 147 F. Supp. 2d 274 (D.N.J. 2001).

⁸³ See Moss v. Comm’r, 135 T.C. 365 (Sept. 20, 2010).

⁸⁴ Treas. Reg. § 1.469-9(d)(1).

⁸⁵ Treas. Reg. § 1.469-9(d)(2).

⁸⁶ I.R.C. § 469(c)(7); Treas. Reg. § 1.469-9(e)(1) and (g).

⁸⁷ Treas. Reg. § 1.469-9(e)(3)(i).

a real estate operator and for purposes of grouping rental real estate.⁸⁸ The aggregation election is binding for the year in which it is made and all subsequent years unless there is a material change in circumstances.⁸⁹

a. Real Estate Owned by Entity. In situations where a real estate activity is held through a legal entity such as a partnership, the taxpayer will be considered to hold his interests in the same way as the entity. That is, the taxpayer will be treated as holding a single interest if the entity groups its interests as a single activity.⁹⁰ If the entity treats each as separate, then each will be treated as separate to the taxpayer. However, if the taxpayer owns 50% or more of the capital, profits or losses of the pass-through entity, each interest will be treated as separate with respect to the taxpayer regardless of how the entity treats the interests.⁹¹ Notwithstanding this rule, the taxpayer may elect to treat the interests as a single activity even if they are held through a pass-through entity.⁹²

b. Limited Partners. The Internal Revenue Code provides what appears at first glance to be a serious handicap in the case of limited partners. Section 469(h)(2) specifically provides that no interest in a limited partnership as a limited partner will be treated as an interest in which the taxpayer materially participates. The rental real estate exception defers to this limitation stating that nothing in the exception will affect the determination of whether the taxpayer participates with respect to any interest as a limited partner.⁹³ However, the regulations do provide some relief allowing the taxpayer to be treated as if they were not a limited partner if they satisfy the material participation standard. If the taxpayer has elected to treat all interests in rental real estate as a single interest and one of the interests aggregated is a limited partner interest, the entire combined rental real estate activity will be treated as a limited partnership interest for purposes of determining material participation.⁹⁴ In which case, the taxpayer may only satisfy the material participation test for the entire grouping in one of the three ways permitted for limited partner interests.⁹⁵

c. LLCs Distinguished from LPs. For this purpose, the IRS has put forth, and lost, in multiple cases the argument that interests in other limited liability entities such as LLCs are equivalent to a limited partnership interests because both are designed to limit the liability of the interest holders. The courts have distinguished the two noting that limited partnerships are treated as *per se* passive because a limited partner is statutorily prevented from participating actively in the partnership's affairs.⁹⁶ However, the same statutory constraint does not apply to members of LLCs.

d. Proposed Regulations. After multiple losses on the point, the IRS stopped litigating the issue and issued proposed regulations.⁹⁷ In those regulations, an interest in a limited partnership will be deemed if: (A) an entity in which such interest is held is classified as a partnership for federal income tax purposes; and (B) the holder of the interest does not have rights to manage the entity at all times during the taxable year pursuant to state law and the governing agreement. The proposed regulation also provides that if the individual holds another interest in the partnership that is not a limited partner interest, e.g., a general partner interest, the individual shall not be treated as holding a limited partner interest.

3. Material Participation

The taxpayer must next determine whether he materially participates in the activities.

⁸⁸ See CCA 201427016 (July 3, 2014) (finding that whether a taxpayer is a real estate operator under I.R.C. § 469(c)(7)(B) is not affected by the election to group all the taxpayer's interests in rental real estate activities, but rather the election is relevant only after the taxpayer has determined he is a real estate operator).

⁸⁹ Treas. Reg. § 1.469-9(g)(1).

⁹⁰ Treas. Reg. § 1.469-9(h)(1).

⁹¹ Treas. Reg. § 1.469-9(h)(2).

⁹² Treas. Reg. § 1.469-9(h)(1).

⁹³ I.R.C. § 469(c)(7)(A).

⁹⁴ Treas. Reg. § 1.469-9(f)(1).

⁹⁵ A *de minimis* exception exists if the taxpayer's aggregated interests includes interests other than through a limited partnership and the taxpayer's gross rental income from taxpayer's limited partnership interest is less than 10% of the gross rental income from all of the taxpayer's interests. Treas. Reg. § 1.469-9(f)(2).

⁹⁶ See, e.g., *Thompson v. U.S.*, 87 Fed Cl. 728 (2009); *Garnett v. Comm'r*, 132 T.C. 369 (2009); *Gregg v. Comm'r*, 186 F. Supp. 2d 1123 (D. Or. 2000).

⁹⁷ See Prop. Treas. Reg. § 1.469-5(e).

a. Material Participation Test in Regs. The test can be met with respect to an activity in any of the following ways:⁹⁸

(1) The individual participates in the activity for more than 500 hours during the taxable year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in the activity of all individuals;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity is not less than the participation in the activity of any other individual;

(4) The activity is a significant participation activity and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. A significant participation activity for this purpose is defined as a trade or business in which the individual participates for more than 100 hours during the year and would not otherwise be treated as an activity in which the individual materially participates;⁹⁹

(5) The individual materially participates in the activity for any 5 taxable years (whether or not consecutive) during the immediately preceding 10 taxable years;

(6) The activity is a personal service activity and the individual materially participated in the activity for any of the three taxable years preceding the taxable year (whether or not consecutive); or

(7) The individual is treated as materially participating based on all of the facts and circumstances on a regular, continuous and substantial basis.¹⁰⁰

b. Regular, Continuous and Substantial Basis. In order to determine whether a taxpayer is materially participating in an activity, the taxpayer will be so treated only if he is involved in the operations of the activity on a regular, continuous and substantial basis.¹⁰¹ The regulations provide a broad test to determine what types of activities qualify for purposes of material participation stating that "any work done by an individual in connection with an activity in which the individual owns an interest shall be counted."¹⁰² Only two limitations are provided in the regulations. In addition to services performed as an investor which are discussed above, work that is of a type not customarily done by an owner of an activity and work where the principal purpose of its performance is to avoid the disallowance of losses will not count towards determining material participation.¹⁰³

c. Indicia of Lack of Participation. The IRS has indicated the following are indicia of lack of participation:

⁹⁸ The regulations provide that the extent of a taxpayer's participation may be established by any reasonable means. Contemporaneous daily time reports, logs or similar documents are not required if another reasonable means can be established including identification of services performed over a period of time and the approximate number of hours spent performing services during such period. Treas. Reg. § 1.469-5T(f)(4). However, it would be advisable for the taxpayer to complete contemporaneous record-keeping through a log or other similar documentation.

⁹⁹ Treas. Reg. § 1.469-5T(c)(2).

¹⁰⁰ Treas. Reg. § 1.469-5T(a). If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under (7) above. In addition, for (7) above, the services of a taxpayer will not be taken into account in determining material participation unless, for the taxable year:

- No person (other than the individual) who performs services in connection with the management of the activity receives compensation in the form of wages, salaries, professional fees and other amounts received as compensation for personal services actually rendered, and
- No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual. Treas. Reg. § 1.469-5T(b)(2)(ii).

¹⁰¹ I.R.C. § 469(h)(1).

¹⁰² Treas. Reg. § 1.469-5(f)(1).

¹⁰³ Treas. Reg. § 1.469-5T(f)(2)(i). The example provided in the regulations is of a lawyer who owns a professional football league and employs his wife as secretary to count her hours towards material participation. Treas. Reg. § 1.469-5T(k) *example 7; compare Lamas*, T.C. Memo. 2015-59 (finding that restoring assets and opportunities and finding potential investors were the type of activities customarily done by owners).

- (1) The taxpayer received no compensation for services.
- (2) The taxpayer's residence is located far from the activity (e.g., 100s of miles).
- (3) The taxpayer has a separate full-time job for which he receives a W-2 and significant compensation.
- (4) The taxpayer has many other investments, business activities, rentals, or hobbies that absorb significant amounts of time.
- (5) The day-to-day oversight and care of the operations are provided by paid on-site management/foreman/supervisor and/or employees who provide.
- (6) The taxpayer has health issues or is elderly.
- (7) There is no material impact on operations due to the majority of the hours claimed.
- (8) If taxpayer stopped performing the services claimed, the operations would continue uninterrupted.¹⁰⁴

V. 1031 EXCHANGES AND DELAWARE STATUTORY TRUSTS

Section 1031 allows taxpayers to postpone paying tax on the gain on a sale of real estate if the proceeds of the sale are reinvested in similar property as part of a qualifying like-kind exchange.

A. Statutory Framework

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

The Section does not apply to exchanges of inventory (property held primarily for sale), stock, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, or certificates of trust or beneficial interests.¹⁰⁵

It is also worth noting that Section 1031 treatment is mandatory. It is not subject to election or waiver. Therefore, if the recognition of gains or losses is desired, the transfer should be structured to intentionally fall outside of the section's application. Any loss realized on a Section 1031 exchange is not recognized even if money or qualifying property is received.¹⁰⁶

1. Exchange Requirement

a. General Rule. A transaction will be treated as an exchange if there is a reciprocal transfer of property as distinguished from a transfer of property for money consideration only.¹⁰⁷

b. Solely. The word "solely" does not mean that a taxpayer who receives non-like kind property in the exchange is entirely outside Section 1031. If a taxpayer receives non-like kind property in the exchange ("boot") or is relieved of a liability (also treated as "boot"), the transaction will not qualify for complete nonrecognition treatment but may qualify for partial nonrecognition treatment.¹⁰⁸

¹⁰⁴ See Internal Revenue Service, *Passive Activity Loss*, AUDIT TECHNIQUE GUIDE, <http://www.irs.gov/pub/irs-mssp/pal.pdf>.

¹⁰⁵ I.R.C. § 1031(a)(2).

¹⁰⁶ I.R.C. § 1031(c).

¹⁰⁷ Treas. Reg. § 1.1002-1(d).

¹⁰⁸ I.R.C. § 1031(b).

c. Sales Treated as Exchanges. In several instances transactions that were structured as sales have been recharacterized as exchanges by the IRS to disallow a loss claimed by a party to the transaction.¹⁰⁹

d. Intent to Exchange Required. The taxpayer will generally not be permitted to treat two sales of similar property as an exchange when the parties did not intend an exchange at the time of the transactions.¹¹⁰

2. Like Kind Requirement

a. Nature or Character of Property. The property exchanged must be of the same nature or character but it need not be the same quality or grade. Property of one kind or class may not be exchanged for property of another kind or class.¹¹¹ This means that "the distinction intended and made by the statute is the broad one between classes and characters of property, for instance, between real and personal property."¹¹²

b. Examples of Like Kind Property. The Regulations contain illustrations of this broad distinction, stating that real estate that is improved may be exchanged for real estate that is unimproved.¹¹³ City real estate held by an investor can be exchanged for a ranch or farm.¹¹⁴ Similarly, an undivided interest in real estate held as a tenant in common may be exchanged for a fee absolute interest.¹¹⁵ A lease with 30 years or more to run may be exchanged for a fee interest in real estate.¹¹⁶

c. Example of Non-Like Kind Property. Not every exchange of real property meets the like kind requirement. Real property in the United States cannot be exchanged for foreign property. Also, improvements conveyed without the land cannot be conveyed for land. In *Fleming v. Comm'r*, a taxpayer assigned carved-out oil payments in exchange for a fee interest in real estate.¹¹⁷ The Tax Court held the exchanged properties were not like kind properties even though the applicable state law classified the oil payment rights as interests in real property. But in *Comm'r v. Crichton*, the Tax Court held an exchange of an overriding royalty interest in minerals for a city lot was like-kind.¹¹⁸

d. Comparison of Property Rights. In *Koch v. Comm'r*, the Tax Court distinguished *Fleming* and *Crichton* by drawing a distinction between duration of the interests – an overriding royalty interest continues until the mineral deposit is exhausted, whereas a carved-out oil payment right terminates when a specified quantity of minerals has been produced or a stated amount of proceeds from the sale of minerals has been received.¹¹⁹ In determining whether a like kind exchange has been achieved, the *Koch* court stated the analysis:

...requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, section 1031(a) refers to property of a like—not an identical—kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.

3. Use of Property

The property transferred and the property received must both be held by the taxpayer for productive use in a trade or business or for investment.

¹⁰⁹ Rev. Rul. 61-119, 1961-1 C.B. 395.

¹¹⁰ *Mars v. Comm'r*, T.C. Memo. 1987-481.

¹¹¹ Treas. Reg. § 1.1031(a)-1(b).

¹¹² *Comm'r v. Crichton*, 122 F.2d 181, 182 (5th Cir. 1941).

¹¹³ Treas. Reg. § 1.1031(a)-1(b).

¹¹⁴ *Id.*

¹¹⁵ Rev. Rul. 73-476, 1973-2 C.B. 300.

¹¹⁶ Treas. Reg. § 1.1031(a)-1(c).

¹¹⁷ 24 T.C. 818, 823-824 (1955).

¹¹⁸ 122 F.2d 181, 182 (5th Cir. 1941); *see, e.g.*, Rev. Rul. 68-331, 1968-1 C.B. 352 (discussing an interest in a producing oil and gas lease exchanged for a ranch); Rev. Rul. 55-749, 1955-2 C.B. 295 (discussing land exchanged for perpetual water rights).

¹¹⁹ 71 T.C. 54 (1978).

a. Investment and Trade or Business Property. Property held for productive use in a trade or business may be exchanged for investment property and vice versa. Therefore, the distinction between these two categories is unimportant for purposes of Section 1031.¹²⁰ The requirement that the property be used for one of these two purposes is to exclude personal use property from the 1031 exchange rules.

b. Personal Use Property. Exchanges of non-business or personal use property do not qualify for like-kind exchange treatment. However, a minimal amount of personal use may not disqualify the property from being trade or business or investment property.¹²¹

c. Inventory. Property held primarily for sale does not qualify for nonrecognition treatment under §1031.¹²² However, a dealer may hold property for productive use in a trade or business or for investment if such property is properly segregated. Whether property is held for sale is a question of fact.

d. Recent Acquisitions. Property acquired for an exchange is not "held for use in a trade or business or for investment" and an exchange of such property will not qualify for §1031 treatment.¹²³

4. Timing

The exchange of properties need not occur simultaneously for nonrecognition treatment to be available. In certain circumstances, Section 1031 treatment is available when the receipt of the replacement property is deferred.

a. Identification of Replacement Property in 45 Days. The replacement property must be identified within 45 days of the transfer of the relinquished property (the "identification period"). If multiple properties are relinquished, the identification period begins on the earliest date on which a transfer occurs.¹²⁴

(1) *Evidence.* The replacement property must be identified in (i) a written document signed by the taxpayer and delivered, mailed, telecopied, or otherwise sent to the transferor of the relinquished property or another person involved in the exchange, such as an intermediary, an escrow company or title company; or (ii) a written exchange agreement signed by all parties to the exchange before the end of the identification period.¹²⁵

(2) *Identification of Alternative and Multiple Properties.* The maximum number of replacement properties that may be identified is (i) three properties without regard to their fair market values or (ii) any number of properties so long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of the relinquished properties.¹²⁶

(3) If the taxpayer identifies more properties than permitted, the taxpayer is treated as if no replacement properties had been identified.¹²⁷

(4) Revocation of an identified property may occur at any time before the end of the identification period.¹²⁸

b. Receipt of Replacement Property within 180 Days. The replacement property must be received on or before the earlier of (i) 180 days from the date of the transfer of the relinquished property or (ii) the due date of the taxpayer's tax return (including extensions) for the tax year in which the transfer of the relinquished property occurred.¹²⁹

¹²⁰ Treas. Reg. § 1.1031(a)-1.

¹²¹ PLR. 8103117 (Oct. 27, 1980); see Rev. Proc. 2008-16, 2008-1 C.B. 547 for a safe harbor test applicable to dwelling units.

¹²² I.R.C. § 1031(a)(2)(A).

¹²³ Rev. Rul. 77-337, 1972-2 C.B. 305; see also Rev. Rul. 84-121, 1984-2 C.B. 168.

¹²⁴ I.R.C. § 1031(a)(3)(A); see also Treas. Reg. § 1.1031(k)-1(b)(2)(iii).

¹²⁵ Treas. Reg. § 1.1031(k)-1(c)(2).

¹²⁶ Treas. Reg. § 1.1031(k)-1(c)(4).

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ Treas. Reg. § 1.1031(k)-1(b)(2)(ii).

c. Substantially Same Property as Identified. The replacement property identified must be substantially the same property as the property identified. This should be satisfied if at least 75% of the fair market value of the identified replacement property is received.¹³⁰

d. Avoid Constructive Receipt. It is important to know that taking control of cash or other proceeds before the exchange is complete may disqualify the entire transaction from like-kind exchange treatment and make ALL gain immediately taxable. If the taxpayer transfers the relinquished property and receives money or other property in consideration for the relinquished property before the taxpayer receives the replacement property, the transaction will be treated as a sale rather than an exchange, even though the taxpayer may ultimately receive like-kind property.¹³¹

(1) *Actual Receipt.* The taxpayer is in actual receipt of the money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property.¹³²

(2) *Constructive Receipt.* The taxpayer is in constructive receipt of the money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so the taxpayer may draw upon it immediately or after giving proper notice.¹³³

5. Reverse Exchanges

Treasury Regulations issued in 1991 for Section 1031 exchanges did not apply to exchanges where the replacement property was acquired first, and then relinquished property is sold. Acknowledging this, the IRS issued Rev. Proc. 2000-31, stating that the IRS would not challenge reverse exchanges, and setting forth safe harbors.¹³⁴

a. Qualified Exchange Accommodation Arrangement. Rev. Proc. 2000-31 provides that the IRS will not challenge the qualification of property as either “replacement property” or “relinquished property” for purposes of Section 1031 and the regulations thereunder, or the treatment of the exchange accommodation titleholder (as defined below) as the beneficial owner of such property for federal income tax purposes, if the property is held in a qualified exchange accommodation arrangement, or “QEAA”.¹³⁵ Property is held in a QEAA if the following requirements are met:

(1) Legal title to or beneficial ownership of the property is held by a person (the “exchange accommodation titleholder”) who is not the taxpayer or a disqualified person and either such person is subject to federal income tax or, if such person is treated as a partnership or S corporation for federal income tax purposes, more than 90 percent of its owners are partners or shareholders who are subject to federal income tax;

(2) At the time the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for Section 1031 treatment;

(3) No later than five business days after the transfer of property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the “qualified exchange accommodation agreement”) that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under Section 1031 and Rev. Proc. 2000-31, and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-31. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with the agreement;

(4) No later than 45 days after the transfer of the replacement property to the exchange accommodation titleholder, the relinquished property must be properly identified in the manner described in Treas. Reg. § 1.1031(k)-1(c). The taxpayer may properly identify alternative and multiple properties;

¹³⁰ Treas. Reg. § 1.1031(k)-1(d)(2) Ex.4(ii).

¹³¹ Treas. Reg. § 1.1031(k)-1(f)(2).

¹³² Treas. Reg. § 1.1031(k)-1(f)(2).

¹³³ Treas. Reg. § 1.1031(k)-1(f)(2).

¹³⁴ 2000-2 C.B. 146.

¹³⁵ *Id.*

(5) No later than 180 days after the transfer of the replacement property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in Treas. Reg. § 1.1031(k)-1(g)(4))) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and

(6) The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

b. Permissible Agreements. Rev. Proc. 2000-31 also lists certain contractual terms that may be included in the QEAA between the exchange accommodation titleholder and the taxpayer that will not unwind the protection of the safe harbor. These provisions include guarantees, indemnities, leasebacks, puts and calls.

6. Qualified Intermediaries

To facilitate deferred exchanges and reverse exchanges, the IRS has sanctioned the use of intermediaries to acquire replacement property for a taxpayer and exchange it for the taxpayer's relinquished property, which the intermediary then holds until it is sold.

a. Transaction Steps. The funds to acquire the replacement property are loaned to the intermediary by the taxpayer. After the intermediary acquires the taxpayer's property, the taxpayer's loan to the intermediary is secured by a deed of trust on the taxpayer's replacement property. When the taxpayer is ready to close on the sale of the property to be relinquished, the taxpayer exchanges property with the intermediary, who will convey the taxpayer's relinquished property to the purchaser of that property.

b. Disqualified Persons. The taxpayer cannot act as his own intermediary. Nor can the taxpayer's agent (including the real estate agent or broker, investment banker or broker, accountant, attorney, employee or anyone who has worked for the taxpayer in those capacities within the previous two years).¹³⁶

c. Written Agreement. To be a "qualified" intermediary, the intermediary must enter into a written agreement with the taxpayer to facilitate the exchange pursuant to which the intermediary will (1) acquire the relinquished property from the taxpayer, (2) transfer the relinquished property to its purchaser, (3) acquire the replacement property, and (4) transfer the replacement property to the taxpayer.¹³⁷

d. The "exchange accommodation titleholder" described in Rev. Proc. 2000-37¹³⁸ is a type of "qualified intermediary".

e. Taxpayers are cautioned to be careful in the selection of a qualified intermediary as there have been incidents of intermediaries declaring bankruptcy or otherwise being unable to meet their contractual obligations to the taxpayer. These situations have resulted not only in losses to the taxpayers, but also have caused taxpayers to not meet the strict timelines set for a deferred or reverse exchange, thereby disqualifying the transaction from Section 1031 deferral of gain.

7. Basis

The taxpayer's basis in the replacement property is same as the basis in the property relinquished, decreased by the amount of any boot received and increased by the amount of any gain recognized in the exchange. If the taxpayer gives consideration in addition to the like-kind property his basis in the replacement property is increased by the amount of the additional consideration given.¹³⁹

8. Special Rules and Exceptions

a. No Deferral for Exchange Between Related Persons. If a taxpayer exchanges property with a related person, gain will be recognized if (i) the related person disposes of the property received from the taxpayer or

¹³⁶ Treas. Reg. § 1.1031(k)-1(k).

¹³⁷ Treas. Reg. § 1.1031(k)-1(g)(4)(iii).

¹³⁸ 2000-2 C.B. 308.

¹³⁹ Treas. Reg. § 1.1031(d)-1(a).

(ii) the taxpayer disposes of the property received from the related person within two years after the date of the last transfer that is part of the exchange.¹⁴⁰

(1) *Gain or Loss Realized When Property Disposition Occurs.* The gain or loss to the taxpayer as a result of the subsequent disposition of the property (by either the taxpayer or the related person) is recognized when the subsequent disposition occurs. Therefore, a temporary deferral of gain still occurs.¹⁴¹

(2) *Related Person.* A related person is a person that is related to the taxpayer within Section 267(b) or Section 707(b)(1).¹⁴²

(3) *Exceptions.* The disposition will not trigger recognition if it occurs:

(a) After the earlier of the death of the taxpayer or the death of the related person;

(b) In a compulsory or involuntary conversion under Section 1033 if the exchange occurred before the threat of imminence of such conversion; or

(c) If it is established that neither the exchange nor the disposition had as one of its principal purposes the avoidance of Federal income tax.¹⁴³

b. Entity Ownership. Section 1031(a)(2)(D) excludes exchanges of partnership interests from receiving nonrecognition treatment. Treas. Reg. § 1.1031(a)-1(a)(i) provides that Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. Thus, if taxpayer A owns a 25% tenant in common interest in raw land, he can sell his 25% tenant in common interest to taxpayer B in exchange for a 100% interest in taxpayer B's office park; but if taxpayer A and his co-tenants are treated as partners under Treas. Reg. § 301.7701-1(a)(2), taxpayer A cannot enter into the exchange unless he can convince the other partners to the partnership to sell the property in exchange for the office park. The partnership would then own the office park and would presumably receive cash to boot.

c. Permissible Entities. The sole ownership interest in a single member LLC that is disregarded for Federal income taxes can be exchanged for real property under Section 1031(a), if the LLC owns real property of like kind.¹⁴⁴

B. Tenancies in Common

Because owners of tenancy in common interests can exchange their undivided fractional interest and qualify for income tax deferral under Section 1031, enterprising individuals began to market co-tenancy interests that could be used in tax-free exchanges. These sponsors will package co-ownership interests for sale by acquiring property, negotiating a master lease on the property, and arranging for financing. An investor can buy a tenancy in common interest in the arrangement as a way of liquidating another property on an income tax deferred basis.

1. Risk of Partnership Treatment

Courts have looked at the relationships not only among the co-owners of these sponsored tenancies in common, but also between the sponsor (or persons related to the sponsor) and the co-owners in determining whether the co-ownership gives rise to a partnership.

a. Bergford v. Commissioner. In *Bergford v. Comm'r*, seventy-eight investors purchased "co-ownership" interests in computer equipment that was subject to a 7-year net lease.¹⁴⁵ As part of the purchase, the co-owners authorized the manager to arrange financing and refinancing, purchase and lease the equipment, collect rents and apply those rents to the notes used to finance the equipment, prepare statements, and advance funds to participants on an

¹⁴⁰ I.R.C. § 1031(f)(1).

¹⁴¹ I.R.C. § 1031(f)(1).

¹⁴² I.R.C. § 1031(f)(3).

¹⁴³ I.R.C. § 1031(f)(2).

¹⁴⁴ PLR 200118023 (May 7, 2001).

¹⁴⁵ 12 F.3d 166 (9th Cir. 1993).

interest-free basis to meet cash flow. The agreement allowed the co-owners to decide by majority vote whether to sell or lease the equipment at the end of the lease. Absent a majority vote, the manager could make that decision. In addition, the manager was entitled to a remarketing fee of 10 percent of the equipment's selling price or lease rental whether or not a co-owner terminated the agreement or the manager performed any remarketing. A co-owner could assign an interest in the co-ownership only after fulfilling numerous conditions and obtaining the manager's consent. The court held that the co-ownership arrangement constituted a partnership for federal tax purposes. Among the factors that influenced the court's decision were the limitations on the co-owners' ability to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances).¹⁴⁶

b. Treasury Regulations. Under Treas. Reg. §§ 1.761-1(a) and 301.7701-1 through 301.7701-3, a federal tax partnership does not include mere co-ownership of property where the owners' activities are limited to keeping the property maintained, in repair, rented or leased. However, a partnership for federal tax purposes is broader in scope than the common law meaning of partnership and may include groups not classified by state law as partnerships.¹⁴⁷ Where the parties to a venture join together capital or services with the intent of conducting a business or enterprise and of sharing the profits and losses from the venture, a partnership (or other business entity) is created.¹⁴⁸ Furthermore, where the economic benefits to the individual participants are not derivative of their co-ownership, but rather come from their joint relationship toward a common goal, the co-ownership arrangement will be characterized as a partnership (or other business entity) for federal tax purposes.¹⁴⁹

2. Guidance from the IRS

a. Revenue Procedure 2002-22. Recognizing the importance of tenancy in common and not partnership treatment for purposes of Section 1031 treatment, the IRS published Rev. Proc. 2002-22 setting forth the requirements that must be met for a tenant in common interest to be considered by the IRS for a “no partnership” private letter ruling.¹⁵⁰ Some of those requirements were:

- (1) The co-owners must hold title to the real property as tenants in common.
- (2) There can be no more than 35 co-owners, except that a married couple is treated as a single owner and all persons who inherit from a deceased owner are treated as a single owner.
- (3) The co-ownership may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying any or all of the co-owners as partners, shareholders, or members of a business entity, or otherwise hold itself out as a partnership or other form of business entity (nor may the co-owners hold themselves out as partners, shareholders, or members of a business entity). The IRS generally will not issue a ruling if the co-owners held interests in the property through a partnership or corporation immediately prior to the formation of the co-ownership.
- (4) The co-owners may enter into a limited co-ownership agreement that may run with the land. For example, a co-ownership agreement may provide that a co-owner must offer the co-ownership interest for sale to the other co-owners, the sponsor, or the lessee at fair market value before exercising any right to partition; or that certain actions on behalf of the co-ownership require the vote of co-owners holding more than 50 percent of the undivided interests in the property.
- (5) The co-owners must unanimously approve of the hiring of any manager, the sale or other disposition of the property, any leases of a portion or all of the property, the creation or modification of a blanket lien, or the negotiation of any management contract (or any extension or renewal of such contract). For all other actions on behalf of the co-ownership, the co-owners may agree to be bound by the vote of those holding more than 50 percent of the undivided interests in the property.

¹⁴⁶ See, e.g., *Bussing v. Comm'r*, 88 T.C. 449 (1987), *aff'd on reh'g*, 89 T.C. 1050 (1987); *Alhouse v. Comm'r*, T.C. Memo. 1991-652.

¹⁴⁷ *Bergford*, 12 F.3d at 169.

¹⁴⁸ *Bussing*, 88 T.C. at 460.

¹⁴⁹ *Bergford*, 12 F.3d at 169.

¹⁵⁰ 2002-1 C.B. 733.

(6) Rev. Proc. 2002-22 continues to list ten other requirements that must be met in order for a comfort ruling to be issued that the co-tenancy is not a partnership. The last of these requirements is that the payment to the sponsor for the acquisition of the co-ownership interest (and the amount of any fees paid to the sponsor for services) must reflect the fair market value of the acquired co-ownership interest (or the services rendered) and may not depend, in whole or in part, on the income or profits derived by any person from the property.

b. PLR 200513010. PLR 200513010 is one of the first rulings issued under Rev. Proc. 2002-22. It was significant because the sponsor maintained a TIC interest in the property and stayed on as a co-owner. The IRS ruled that the requirements of Rev. Proc. 2002-22 were followed and no partnership was created.¹⁵¹

C. Delaware Statutory Trusts

Delaware Statutory Trusts ("DSTs") have emerged as an alternative to tenant in common co-ownership for purposes of engaging in Section 1031 exchanges.

1. Overview

A Delaware Statutory Trust is a separate legal entity created as a trust under the laws of Delaware in which each owner has a "beneficial interest" in the DST for federal income tax purposes and is treated as owning an undivided fractional interest in the property.

Due to the restrictions for DST qualification, the best attributes for a DST are generally single-tenant occupancy, an investment-grade tenant with a long-term lease to avoid turnover costs, and triple net lease terms that require the tenant to pay all property expenses.

a. Delaware Statutory Trust Act. Del. Code Ann. Title 12 § 3801(g) defines a Domestic Statutory Trust as an unincorporated association which:

(1) Is created by a governing instrument under which property is or will be held, managed, administered, controlled, invested, reinvested and/or operated, or business or professional activities for profit are carried on or will be carried on, by a trustee or trustees or as otherwise provided in the governing instrument for the benefit of such person or persons as are or may become beneficial owners or as otherwise provided in the governing instrument, including but not limited to a trust of the type known at common law as a "business trust," or "Massachusetts trust," or a trust qualifying as a real estate investment trust under I.R.C. § 856 *et seq.*, or under any successor provision, or a trust qualifying as a real estate mortgage investment conduit under I.R.C. § 860D, as amended, or under any successor provision; and

(2) Files a certificate of trust pursuant to Del. Code Ann. Title 12 § 3810.

b. Revenue Ruling 2004-86. Rev. Rul. 2004-86 specifically allows the use of a DST to acquire real estate where the beneficial interests in the trust will be treated as direct interests in replacement property for purposes of Section 1031.¹⁵²

c. Required Features of the DST. In order for a DST to qualify for a 1031 exchange, the trustee may not have the power to do any of the following:¹⁵³

- (1) Accept contributions from either current or new investors after the offering is closed;
- (2) Renegotiate the terms of the existing loans, or borrow any new funds from a third party;
- (3) Sell real estate and use the proceeds to acquire new real estate;

¹⁵¹ PLR 200513010 (Apr. 1, 2005).

¹⁵² 2004-2 C.B. 191.

¹⁵³ *Id.*

- (4) Make other than minor repairs that are considered (a) normal repair and maintenance, (b) minor non-structural improvements, and (c) those required by law;
- (5) Invest cash held between the distribution dates other than in short-term government debt;
- (6) Retain cash, other than necessary reserves (all cash must be distributed on a current basis); or
- (7) Enter into new leases or renegotiate the current lease.

2. Advantages of DSTs

An investment in a DST can be advantageous to an owner of real property who wants the deferral of a 1031 exchange for an existing property, but who wants to relinquish control of day to day real estate management and who doesn't want to spend the time and effort finding a suitable replacement property. The relinquishing property owner can exchange into a DST and receive stable returns, typically for a 2 to 10-year period. Advantages of DSTs over tenancies in common are:

- a. Greater exit strategies for the investor. When transfer of ownership occurs, the banks are not involved.
- b. The ability to have more diversification options available during the 45-day identification period.
- c. The limitation to 35 investors set forth in Rev. Proc. 2002-22 also does not apply. This allows offerings to 100 or more investors, with the minimum investment amounts in a more reasonable range of \$100,000 to \$250,000.
- d. No need to set up individual single member LLCs. The DST itself shields investors from any liability.
- e. Lenders view the trust as only one borrower (rather than having up to 35 borrowers as in many TIC arrangements), which makes it easier and less expensive to obtain financing. Because the investor's only right with respect to the DST is to receive distributions and the investor has no voting authority regarding the operation of the property, "bad boy carve outs" are eliminated and the lender looks only to the DST sponsors (the Trustees) for these carve outs from the non-recourse provisions of a note.

VI. SPECIAL ISSUES WITH LIFETIME TRANSFERS OF REAL ESTATE

A. Planning with Negative Capital Accounts

A real estate investor who desires to make a gift to his or her descendants will typically want to give an interest in either a new or stabilized project, which involves the transfer of a membership interest in an LLC or a limited partner interest in a partnership. To determine the amount of the gift, the value of the entire development project must be appraised, and then the membership interest being gifted must be appraised, usually applying discounts for lack of control and lack of marketability.¹⁵⁴ The value of the gift is then reduced by the amount of debt from which the donor is relieved. This relief of indebtedness in the form of transferring the donor-member's or donor-partner's share of the entity's liabilities can have negative income tax consequences to the donor.

1. Liabilities in Excess of Basis

If the LLC or partnership owns debt-financed property, the donor-member's proportionate share of that liability is allocated to his capital account. If the member is also taking a depreciation deduction on his proportionate share of the LLC's real property each year, his basis is being reduced by those depreciation deductions. After years of depreciation deductions and

¹⁵⁴ For a discussion of applicable discounts, see Farhad Aghdami, *Dishing the Dirt on Planning for Real Estate Investors*, 52 U. MIAMI HECKERLING INST. ON EST. PLAN. 14 (2018).

basis reductions, it is likely that the donor's share of the partnership liabilities will exceed his inside basis in his partnership interest. This is referred to as a "negative tax basis capital account".

a. Treas. Reg. § 1.1001-2(a)(1) states that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

b. Treas. Reg. § 1.1001-2(a)(4)(iii) specifically states that a transfer by gift is a type of "disposition" included in the gain recognition rule.

c. In the gift context, the donor will recognize gain to the extent that the share of liabilities allocable to the transferred interest exceeds the donor's inside basis. In other words, the donor can be treated as having sold the interest for the amount of his share of the entity indebtedness even though the transaction looks like a gift.

d. Some of the gain recognized may be ordinary, depending on whether the "hot asset" rules of Section 751 apply. The "hot asset" rules require the seller to look through the partnership and see what assets, if sold directly by the entity, would generate ordinary income. Typically, these assets include inventory, unrealized accounts receivables of a cash basis partnership, and depreciable assets that would generate ordinary income recapture if sold.

e. Any capital gain on the deemed sale may be short-term or long-term under the applicable rules.

2. Donee's Basis

If the donor decides that going forward with a gift is worth the accompanying gain recognition (perhaps the assets of the partnership are about to significantly increase in value due to possible rezoning or other changes in circumstance), it is important to understand the impact of the gift on the recipient's basis in the partnership.

a. Sections 742 and 1015. A partner acquiring an interest by gift generally has a basis equal to the donor's basis plus, in some instances, a portion of the gift tax paid.¹⁵⁵

b. Treas. Reg. § 1.1015-4(a). When the donor recognizes gain on the transaction, the amount of the gain is added to the donor's basis in his interest for determining the recipient's basis. In other words, the donor's basis is deemed to be increased by the amount of his gain immediately before the interest is transferred to the recipient. The recipient then has a basis equal to the amount realized (the amount of debt relief) in the deemed sale. However, if the amount of debt relief is greater than the fair market value of the partnership interest at the time of the gift (perhaps on account of valuation discounts), the recipient's basis is adjusted down to the fair market value of the gifted partnership interest.¹⁵⁶

3. Other Issues

a. Section 754 Election in Effect. If the donor partner recognizes a gain on the deemed sale of an interest in a partnership as a result of a gift, and the partnership either made a Section 754 election for that year or has one in effect (see Article VIII, *infra*), the partnership should adjust the inside basis of its assets to reflect the gain.¹⁵⁷

b. Section 704(e) Rules. Any transfer of an interest in a partnership to a family member is subject to the family partnership rules of Section 704(e).¹⁵⁸ Because partnerships can be used to shift income and property appreciation from higher-bracket, older-generation taxpayers to lower-bracket children and grandchildren, these rules are designed to enforce two principles:

(1) Income derived from services should be taxed to the person performing the services. Thus, if 90% of the partnership's income is attributable to the personal services of the gifting partner, but that partner has given away a 49% interest in the partnership, Section 704(e)(1) requires the gifting partner to be paid reasonable compensation before the distributive share is determined.

¹⁵⁵ I.R.C. §§ 742 and 1015.

¹⁵⁶ I.R.C. § 1015(a).

¹⁵⁷ I.R.C. § 754.

¹⁵⁸ I.R.C. § 704(e).

(2) Income produced by capital should be taxed to the true owner of that capital. Thus, Section 704(e)(1) requires that the distributive share of the donee under the partnership agreement can be adjusted by the IRS if the donee is receiving a greater portion of the income than is attributable to the donee's pro rata share of the partnership assets.

4. Grantor Trust Solution

To avoid gain recognition for a transfer of a partnership interest with liabilities in excess of basis, the grantor can defer the problem or perhaps even eliminate it altogether by instead gifting or selling the interest to a grantor trust. Because the grantor trust is treated as a disregarded entity with respect to the grantor for income tax purposes under Sections 671 through 679, the grantor will be treated as continuing to own the transferred asset for income tax purposes, and there will be no gain recognition at the time of the transfer.

a. Termination of Grantor Trust During Grantor's Life. Under *Madorin v. Comm'r*¹⁵⁹ and Treas. Reg. § 1.1001-2(c), Example (5), the conversion of a grantor trust to a non-grantor trust during the grantor's life is treated as a deemed transfer of the assets in the trust from the grantor to the non-grantor trust at the time of the conversion. As a result, if the partnership interest owned by the trust still has a negative capital account at that time, the deemed transfer will result in taxable gain.

b. Termination of Grantor Trust at Grantor's Death. The income tax treatment of a grantor trust at the grantor's death is discussed in Article VII.A, *infra*.

B. Planning for Promote Interests

1. Overview

In the private equity world, the fund manager often receives and is incented with a "carried interest." In the real estate world, this preferred interest is referred to as a "promote" interest and represents the real estate developer's disproportionate share of profits in a real estate deal above a predetermined return threshold. As discussed in Article II.B.4, *supra*, the promote structure is widely used by real estate partnerships as a way to share profits between general and limited partners and as a means to ensure that the interests of the general partner are aligned with the interests of the limited partner investors.

2. Income Taxation of Promote Interest

Under the promote structure, the limited partners grant the general partner (or, in the LLC, the non-managing members grant the managing member) a share of the profits that exceeds the proportion of his or her capital contribution in return for the general partner's entrepreneurial activities and the additional risks he or she bears, as described in Article II.C, *supra*. When the profits received by both limited and general partners are of a capital nature (i.e., capital gains from the sale of an appreciated property), those profits are taxed as capital gains rather than as regular income.

The promote structure is implicated in the policy debate on the taxation of "carried interests", which is aimed at Wall Street hedge fund asset managers. There have been proposals from both the Obama administration and in Congress to tax "carried interest" as ordinary income rather than as a capital gain.¹⁶⁰ The term "carried interest" is defined broadly enough in these revenue-raising proposals that the promote structure used by real estate partnerships would also likely be subject to ordinary income tax.

Arguments in favor of maintaining a promote interest as capital gains and not ordinary income center on the understanding that the promote is not compensation for the general partner; rather, it is a return on the risk the general partner undertakes, as follows:

a. The general partner assumes entrepreneurial risks that the passive limited partner investors are not willing to accept (and often, such as in the case of pension and other institutional equity investors, are not permitted to accept).

¹⁵⁹ 84 T.C. 667 (1985); see also Treas. Reg. § 1.1001(c), Example (5) and Rev. Rul. 77-402, 1977-2 C.B. 222.

¹⁶⁰ In June 2015, Sander Levin (D-MI) introduced the Carried Interest Fairness Act of 2015 (H.R. 2889) to tax investment advisers with ordinary income tax rates. Obama included a line item on taxing carried interest at ordinary income rates in each of his administration's budget blueprints from 2009 through 2012.

b. The general partner often agrees to subordinate his or her return on the promote to the return of the limited partners.

c. The general partner has a higher risk of loss than the limited partners. Because the general partner personally guarantees the transaction financing, the general partner is at risk of losing more than just his or her initial investment; whereas limited partners' liability is limited only to the potential loss of their investment capital.

d. There is also timing risk for the general partner, as the limited partners receive both a return of their initial investment and a priority return thereon before the general partner receives any promote interest.

e. Some general partners also agree to subordinate the various arm's-length negotiated fees (management, construction, etc.) that he or she often receives as compensation for services performed for the partnership. If and when these fees are received, they are taxed as ordinary income to the general partner.

3. Promote Interests

A developer's promote interest in a real estate project is often considered the perfect candidate for a gift or estate freeze transaction, on account of its potential for dramatic upside. In the waterfall example provided in Article II.B.4, *supra*, the developer contributes 10% of the equity to a project and can potentially receive a 46% return if the project is successful. Removing all or part of this appreciation from the developer's estate by transferring the promote interest to a trust for successive generations results in a very transfer-tax efficient planning strategy, especially when coupled with a leveraging technique, such as valuation discounts.

There are various risks and pitfalls associated with an estate planning transfer of a promote interest, discussed in detail in N. Todd Angkatavanich, David A. Handler and Ivan Tabak, *Wealth Transfer Planning with Interests in Private Investment Funds and Other Closely-Held Entities*,¹⁶¹ as applied to carried interests in investment funds, but equally applicable in the real estate promote context. Some of those risks and pitfalls are as follows:

- a. Section 2701 and issues with the safe harbor strategy of giving "vertical slice" interests
- b. Section 2036 retained interest issues
- c. Valuation uncertainty for gift tax purposes
- d. Incomplete gift issues for unvested interests
- e. Trust and entity attribution rules
- f. Qualified purchaser and accredited investor rules

Section 2701 and the valuation uncertainty issues will be discussed in more detail below. In order to provide a framework for the discussion, consider the following example as a continuation from the three-tiered waterfall example illustrating a promote interest at Article II.B.4, *supra*.

A developer, Bob Sponsor, already has a few successful real estate development projects under his belt and cash in the bank. He is entering into a new project and will contribute to "New Project LLC" land worth \$5 million and cash of \$5 million for a 10% Class A membership interest. His equity investor partner will contribute \$90 million in cash for an 90% Class A membership interest. Bob will also receive a Class B interest with no invested capital. Both the Class A and B interests will be non-managing members, and a Management LLC owned wholly by Bob will be the manager of the LLC. Bob will personally guarantee the financing of the construction loan and his Management LLC will be paid certain development fees at various percentage of construction completion targets in the development process.

All net cash flow and profits will be allocated to the Class A members up to the first \$110 million received (a 10% IRR). From and following that point, net cash flow and profits will be allocated 25% to the Class B interest and 75% to the Class A interest until the Class A interest has received \$120 million (a 20% IRR).

¹⁶¹ 50 U. MIAMI HECK. INST. ON EST. PLAN. III-D (2016).

From and following that point, net cash flow and profits will be allocated 40% to the Class B member and 60% to the Class A members.

Bob wants to make a gift of a portion of his Class B membership interest to a dynasty trust for his descendants, since the Class B interest (the promote interest) presumably has no value and the greatest potential for upside.

4. Section 2701 and Vertical Slice Gifts

When considering gifts of carried interests (and, in turn, promote interests) to younger family members, a starting point is the structure of the gift, which must factor in Section 2701. Section 2701, part of the special valuation rules of Chapter 14 of the Code, was enacted to curb abuses in transfers of closely-held business interests to lower generations in the family.

Prior to Chapter 14, a common transfer might have looked like this: Mom holds a majority interest in a closely-held corporation and decides to make a gift to trusts for her children. Prior to the gift, Mom causes the company to restructure its stock so that Mom holds a preferred interest and a common interest. Mom's preferred interest is granted certain discretionary rights, such as the right to force distributions, compel liquidation, and create various puts and calls. The common interest would have none of these rights, and it would typically be a non-voting interest. A premium would be placed on Mom's preferred stock on account of the discretionary rights that were unlikely to be exercised. By using the "subtraction method", the common stock would then receive the rest of the value of the company, which was usually very little. Hence, by artificially inflating Mom's retained interest, the gift tax valuation was significantly depressed.

Chapter 14 imposed a drastic "zero value" rule to this transaction, stating that if Mom's retained interest met certain tests, the value of her interest would be treated as \$0 for gift tax purposes, causing a gift of the value of 100% of Mom's interest to the children's trusts.

a. Section 2701. Section 2701 applies to determine the existence and amount of any gift, whether or not the transfer would otherwise be a taxable gift. For example, Section 2701 can apply to a sale or an exchange for full and adequate consideration. As was shown in the *Karmazin*¹⁶² case, one cannot assume that a sale of a promote interest to a grantor trust in exchange for a promissory note is safe from the application of the 2701 rules.

(1) *Section 2701(a)* provides that solely for purposes of determining whether a transfer of an interest in a corporation or partnership to or for the benefit of a member of the transferor's family is a gift (and the value of such transfer), any "applicable retained interest" that is held by either the transferor or a senior member of the transferor's family after the gift will be valued at zero. The subtraction method will then be used to determine the value of the recipient's interest.¹⁶³ Thus, if an applicable retained interest is held by the transferor or a senior member of the family after the transfer, the full value of the senior family's interest will be deemed to have been transferred to the younger family members.

(2) *Applicable Retained Interest* is defined at Section 2701(b) to include any distribution right if the transferring family owns a controlling interest in the entity immediately before the gift, as well as any put, call, conversion or liquidation right.

(3) *Distribution Right* with respect to partnerships is defined to mean a right to distributions from a partnership with respect to a partner's interest in the partnership,¹⁶⁴ but does not include an interest that is junior to the transferred interest and also does not include a right to receive a guaranteed payment (such as a payment for personal services). So, unless the preferred partnership interest is the gifted interest, almost every transfer of a partnership interest will be implicated by Section 2701.

b. Safe Harbors. Section 2701(a)(b) provides two helpful safe harbors.

¹⁶² T.C. Docket No. 2127-03 (filed Feb. 10, 2003) (IRS argued that an installment note should be treated as having a zero value for gift tax purposes under Section 2702).

¹⁶³ IRC § 2701(a)(3).

¹⁶⁴ IRC § 2701(c).

(1) First, if the interest retained is the same class and thus has the same rights as the interest transferred, Section 2701 does not apply, and normal valuation rules govern the transaction.¹⁶⁵

(2) Second, if the interest retained is proportionally the same as the transferred interest, without regard to nonlapsing differences in voting power, management responsibilities and limitations on liability.¹⁶⁶ This exception is usually referred to as the “vertical slice” safe harbor.

c. Illustration of Safe Harbors. In the example at the outset of this section, if Bob Sponsor wanted to make a gift of his Class B promote interest without running afoul of the Section 2701 zero value rules, he would need to do one of two things:

(1) *Make a vertical slice gift.* Bob could meet the second safe harbor discussed above if he gave, say, a 20% interest in both his Class A and Class B membership interests to the dynasty trust. This would have an undiscounted value for gift tax purposes of at least \$2 million (20% of Bob’s \$10 million contribution for his Class A interest), and probably more assuming the Class B interest has value (see discussion at Article VI.B.5, *infra*). Bob may be disappointed in this result, especially if he has used all of his lifetime exemption from gift tax.

(2) *Restructure deal to create only one interest.* Similarly, Bob could contribute his \$10 million of capital in exchange for his Class B promote interest, rather than receiving a Class B and a Class A interest. The waterfall could be changed so that the disproportionate distribution amounts would begin once the Class A interest has received a 10% and then a 20% IRR. Bob could then give away an interest in his Class B interest. The same problem arises as with the vertical slice, in that the value of the Class B interest will include Bob’s invested capital and will thus drive up the value of the gift.

d. Vertical Slice Holding Entity. Some practitioners suggest creating a “vertical slice holding company” that will be substituted for Bob in every new project he enters.¹⁶⁷ Bob can then gift an interest in the vertical slice holding company, in which there would only be one class of interests, to the dynasty trust. This has the advantage of maintaining permanent verticality in the development deals. One risk with a traditional vertical slice gift is that there will be a capital call that the dynasty trust would not be able to meet or some other event that diluted or changed ownership interests unintentionally so that the verticality was lost.

e. Keep Older Family Members in Mind. In attempting to achieve verticality, it is important to keep in mind that an interest retained by an “applicable family member” is aggregated with the grantor’s retained interest. An applicable family member includes the transferor’s spouse, the ancestors of the transferor and the transferor’s spouse, and the spouses of any such ancestors.¹⁶⁸ Thus, if Bob’s father-in-law is a 10% owner of the equity investor, Section 2701(e)(3) will attribute the father-in-law’s indirect ownership interest to the New Project LLC. So, 10% of the Class A interest is attributable to the father-in-law, who is an applicable family member with a retained partnership interest entitled to distributions. Suddenly, verticality has been lost, even though Bob fully intended to comply with the vertical slice safe harbor.

5. Promote Derivative Contract

David Handler and others have developed and used the “carry derivative” in the private equity fund and venture capital fund context as a way of avoiding the risks of Section 2701. The same idea could be employed for a promote interest in a real estate deal.

The (very) basic structure of the carry derivative as applied in the real estate promote context is as follows:¹⁶⁹ Bob Sponsor creates a spousal lifetime access trust (or “SLAT”) for the benefit of his spouse and descendants. Bob and the SLAT execute a derivative contract, which has a value “derived” from its underlying asset, the Class B promote interest, which is security

¹⁶⁵ IRC § 2701(a)(2)(B).

¹⁶⁶ IRC § 2701(a)(2)(C).

¹⁶⁷ See N. Todd Angkatavanich, David A. Handler and Ivan Tabak, *Wealth Transfer Planning with Interests in Private Investment Funds and Other Closely-Held Entities*, 50 U. MIAMI HECK. INST. ON EST. PLAN. III-D (2016).

¹⁶⁸ IRC § 2701(e)(2).

¹⁶⁹ Angkatavanich, et al., *Wealth Transfer Planning with Interests in Private Investment Funds and Other Closely-Held Entities*, 50 U. MIAMI HECK. INST. ON EST. PLAN. III-D (2016).

for the contract. Under the terms of the derivative contract, Bob agrees to pay the SLAT a defined amount after a set hurdle is reached.

Bob knows that if the project brings in \$120 million of net cash flow and profit, his Class B interest will receive \$2.5 million (25% of the difference between \$120 million and \$110 million, which are the breaking points for the first tier payment to the Class B member in our example), and if the project brings in \$130 million, he will receive an extra \$4 million (40% of the next \$10 million). In the derivative contract, Bob may agree to pay the SLAT the entire amount collected by the Class B interest after the first \$1 million is received. Alternatively, he could agree to pay the SLAT 50% of all amounts received after the hurdle is reached. Bob could also put a cap on the total amount that could be received by the SLAT.

The value of the underlying Class B promote interest and the value of the derivative contract would both be appraised by a qualified appraiser. The SLAT would then pay Bob the appraised value for the derivative contract.

The benefits of the promote derivative are as follows:

- a. It transfers an economic benefit similar to the promote interest. The transferred value does not have to include a portion of Bob's equity investment in the Class A shares.
- b. It avoids Section 2701 and the need to be concerned about transferring a vertical slice.
- c. Bob is able to specify the amount of wealth he wants to retain and transfer, assuming the development project is as successful as Bob anticipates it will be.
- d. The trust does not need to qualify as an accredited investor, as it may in certain real estate deals.¹⁷⁰
- e. The trust's potential loss is limited to the price of the contract; whereas if the promote interest had been a general partner interest, the trust would have been exposed to more potential liability.
- f. If the promote interest is subject to a vesting schedule, a carry derivative is preferable because it avoids the risk, identified in Revenue Ruling 98-21, 1998-18 IRB 7 (1998) that a gift of the interest is incomplete until vesting occurs.

See Angkatavanich, et. al., *Wealth Transfer Planning with Interests in Private Investment Funds and Other Closely-Held Entities, supra*, for a discussion of the income tax consequences of the derivative contract, which can be deferred or avoided altogether by structuring the purchasing trust as a grantor trust.

6. Valuation Issues

If Bob Sponsor has confidently navigated his way around the Section 2701 issues, the next issue is whether and how to value the Class B promote interest. Bob thinks it has zero value because there are so many contingencies to its ever being realized. Yet, if you offered to buy the interest from Bob for \$0, or even \$1,000, it is unlikely that he would sell it to you because he understands the value of its potential upside.

- a. Caselaw. Only a handful of cases have addressed the issue of valuing a carried interest, and these were not in the context of a gift.

(1) *Diamond v. Commissioner*. In *Diamond v. Commissioner*,¹⁷¹ the Seventh Circuit affirmed a decision by the Tax Court that involved a builder and mortgage broker who received what was essentially a promote interest in exchange for finding financing for a new development project. The question at issue was whether the value of the promote interest was taxable income to the mortgage broker. The Tax Court held that it was, and its value was easily determined because the taxpayer had promptly sold the interest for the sum of \$40,000 a mere three weeks after he acquired it.

¹⁷⁰ To be an accredited investor for purposes of SEC rules, a trust generally must have \$5 million in assets and the trustee must be a sophisticated investor (as defined in Rule 501(a)(7) of Regulation D).

¹⁷¹ 56 T.C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974).

(2) *Campbell v. Commissioner*.¹⁷² A more recent case out of the 8th Circuit concluded that partnership profits interests received by a taxpayer were not includable in income on receipt, because the profits interests were speculative and without fair market value at the time he received them. At trial, the taxpayer presented an expert who had valued the profits interest using a discounted cash flow method. The appraiser had applied significant discounts on account of the interest's restrictions on transferability and lack of participation rights in management. The appraiser also attached no value to the projected tax benefits because of the substantial risk of disallowance on audit. The appraiser's value was that the profits interest was less than \$1,000. The IRS presented an expert who used the same methodology but lower discounts. The Tax Court sided with the IRS appraiser, but the 8th Circuit reversed and held the profits interest had no value.

b. Appraisal. To be safe, the promote interest should be appraised. The appraised value may be very close to zero, but there should be reasoned analysis for that finding by a professional, certified appraiser.

(1) *Discounted Cash Flow Analysis*. An appraiser would typically approach the valuation of the promote interest by applying a discounted cash flow analysis, which would factor in assumptions such as the expected date of the certificate of occupancy, the rate at which pre-leases are expected to be signed or pre-sales completed and the expected revenue generated by those events, the expected costs and cost overruns, the payment of management fees and acquisition fees, the interest on the construction loan and the anticipated timing and amount of net cash flow and profit distributions to the partners. Taken together, these factors and others would produce an expected stream of net cash flow over the anticipated time horizon of the project.

(2) *Discount Factor*. The appraiser would then apply a discount factor to the projected stream of cash flows to arrive at the present value. Given the highly speculative nature of promote interest in terms of both amount and timing, the appropriate discount factor to be used for such a present value calculation likely will be significantly higher than those used to value established, going concern businesses.

(3) *Entity Interest Discounts*. Once the present value is determined, the value of the entity interest may be discounted further to reflect the fact that the promote interest is in almost all cases non-marketable and illiquid and cannot be transferred to third parties (except with consents from lenders that may be difficult to obtain).

VII. AFTER THE GIFT – ISSUES WITH TRUST-OWNED REAL ESTATE

1. Grantor Trust Concerns

An excellent planning technique for the real estate investor is to sell an interest in a development project or a fully-leased project to a grantor trust in exchange for a safe harbor 10% down payment and a promissory note. This transaction would ordinarily qualify for installment sale treatment under Section 453, unless the seller elected out and chose to recognize the entire gain in the year of the sale.¹⁷³ Nevertheless, with a grantor trust, the installment sale rules do not apply, as there has not been a sale for income tax purposes – the grantor is still treated as the owner of the trust property under Rev. Rul. 85-13.¹⁷⁴ When the grantor dies or if grantor trust status is terminated during the grantor's lifetime, the installment sale rules may become applicable.

Perhaps the most debated aspect of an installment sale to an intentionally defective grantor trust is a three-pronged question about the income tax consequences of the grantor's death on (i) any remaining payment obligation under the note, (ii) the basis of the note in the hands of the grantor's heirs, and (iii) the basis of the trust's purchased assets. Commentators have generally aligned themselves along three schools of thought, as follows:

Group 1	Gain recognized at death	Payments are IRD	No basis step-up for note	Basis step-up for trust assets
Group 2	No tax event at death	No IRD	Basis step-up for note	No basis step-up for trust assets
Group 3	No tax event at death	No IRD	Basis step-up for note	Basis step-up for trust assets

¹⁷² *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991).

¹⁷³ I.R.C. § 453(d).

¹⁷⁴ 1985-1 C.B. 184.

For reasons discussed below, most practitioners advise their clients to adopt the positions in Group 2.

1. No Gain Realized at Grantor's Death

In the words of commentator Sam Donaldson, a “critical mass” of practitioners¹⁷⁵ take the position that, upon the death of the grantor of a grantor trust, the grantor is deemed to have made a testamentary transfer of the trust's assets to the trust for income tax purposes (given that the grantor was considered the owner of these assets during his lifetime) and that such transfer does not constitute a gain recognition event under Section 1001.

a. Section 1001(b) states that the amount realized from a disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Thus, gain is not recognized on a lifetime gift, as the donor of a gift receives no monetary consideration.

b. Section 1015 addresses the donee's side of the gift transaction, stating that the donee takes the donor's basis, again implying that the gift transaction does not cause the donor to recognize any gain.

c. Crane v. Commissioner. With bequests and other testamentary transfers, neither the decedent nor the estate receives consideration, so the same logic applies. The U.S. Supreme Court held that a testamentary transfer of property does not constitute a taxable event in *Crane v. Comm'r*.¹⁷⁶ In *Crane*, a surviving spouse inherited an apartment building at her husband's death. The apartment building was encumbered by nonrecourse indebtedness that was exactly equal to the federal estate tax value of the building. Rather than treating the devise of the building to the surviving spouse as a taxable sale for an amount equal to the liability, the Supreme Court indicated that the surviving spouse's basis should be adjusted to the building's fair market value as of the decedent's date of death, unreduced by the indebtedness, as property acquired from a decedent. Thus, the Supreme Court in *Crane* did not view the disposition of the apartment building to the surviving spouse by reason of the decedent's death as a taxable event.

d. Revenue Ruling 73-183. The IRS acquiesced to this logic in Rev. Rul. 73-183¹⁷⁷. In this ruling, the transfer of securities from the decedent to his estate at death did not generate a loss on the decedent's final income tax return as the transfer was not a taxable event. In support of this position, the IRS stated that “the mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income” within the meaning of Section 1001(a).

e. Liabilities in Excess of Basis Exception. As discussed in Article VI.A, *supra*, an exception to the no gain recognition on gifts rule has developed over the years when the gifted property was encumbered by a liability and, as a result of the gift, the donor was relieved of the liability.¹⁷⁸ In this scenario, the debt relief is viewed as consideration, and so the gift becomes a taxable event for income tax purposes.

(1) *Policy for Exception*. Such an exception is necessary to prevent abuse. Absent the exception, a taxpayer could borrow against the equity of an asset up to the asset's fair market value, and then transfer the asset subject to the liability (thus, with little to no gift tax consequences) without recognizing gain. In effect, the taxpayer could convert the asset to cash without recognizing gain.

(2) *Rationale Not Applicable at Death*. This same concern is not present at death, as the taxpayer would have to die to realize the benefit of the debt relief. Accordingly, the exception for debt-encumbered assets has not been applied to testamentary transfers.

(3) *Congressional Support for Position*. Congress expressed support for this stance when it passed the Economic Growth and Tax Relief Reconciliation Act in 2001. In its explanation of Section 1022's

¹⁷⁵ See, e.g., Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 153-154 (September 2002); Samuel A. Donaldson, *Burning Questions (and Even Hotter Answers) about Grantor Trusts*, for the National Association of Estate Planning Councils (2010); Michael D. Mulligan, A “Reality of Sale” *Analysis of Installment Sales to Grantor Trusts: Properly Structured, the Best Transfer Tax Strategy*, White Paper for Lewis Rice LLC (2013 or later, exact date unknown).

¹⁷⁶ 67 S. Ct. 1047 (1947).

¹⁷⁷ 1973-1 C.B. 364.

¹⁷⁸ See *Diedrich v. Comm'r*, 102 S. Ct. 2414 (1982). See also Treas. Reg. § 1.1001-2 (indicating that a disposition by “gift” triggers the exception and containing several examples that all involve transfers during life).

carryover basis rules (effective in 2010 when there was no estate tax), the Conference Committee explicitly endorsed the “no gain” rule by stating: “The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent’s basis in the property.”¹⁷⁹

(4) *Acceptance by Service.* Finally, the IRS seems to have accepted the “no gain on death” rule specifically as it relates to conversions of grantor trusts to non-grantor trusts at the death of the grantor. In Chief Counsel Advice 2009-23024 (Dec. 31, 2008), the Office of the Chief Counsel addressed the tax treatment of a non-grantor trust’s conversion to a grantor trust. The Chief Counsel first reviewed authorities regarding the termination of a grantor trust during the grantor’s lifetime (discussed next), before stating that: “We would also note that the rule set forth in these authorities is narrow, insofar as it only affects *inter vivos* lapses of grantor trust status, not that caused by the death of the owner *which is generally not treated as an income tax event* [emphasis added].” While the IRS’s statement is dicta, it is further evidence that the IRS views the death of the grantor as a non-recognition event.

f. *Minority View.* Despite the existing precedents described above, a minority of practitioners take the opposite position, that a grantor’s death triggers a taxable event with respect to a grantor trust, under the rationale of *Madorin v. Comm’r*.¹⁸⁰ Under *Madorin* and Treas. Reg. § 1.1001(c), Example (5), the termination of grantor trust status during the grantor’s life is treated as a deemed transfer of the assets in the trust from the grantor to the now non-grantor trust, which has a new identity for income tax purposes. As a result, if the trust or its assets are encumbered by liabilities in excess of the trust’s basis in its assets and grantor trust status is terminated during the grantor’s life, the deemed transfer will result in taxable gain. Nevertheless, application of the *Madorin* rule to a deemed transfer resulting from the grantor’s death directly conflicts with the long-standing, constitutionally-accepted principles found in *Crane*, confirmed in Congress’s later finding and upheld by the IRS’s later rulings, as described above. For this reason, most practitioners believe the *Madorin* rationale should be limited to a lifetime termination of grantor trust status.

2. No IRD Triggered at Grantor’s Death

Income in respect of a decedent (or “IRD”) is income to which the decedent was entitled at death and which is not properly reportable for a period prior to the decedent’s death.¹⁸¹ When a sale is reported on the installment method outside of the grantor trust structure, gain attributable to any outstanding payment obligation to the decedent would constitute IRD and be taxable to the decedent’s estate (or the beneficiary of the estate).

a. *Income Requirement.* In order for the IRD rules to apply, however, there must be “income” to which the decedent was entitled. Installment sale payments made during the grantor’s lifetime are not considered income to the grantor because the payments are treated for income tax purposes as payments from the grantor to the grantor. Most practitioners agree that this is the logical and correct result.

b. *Timing of Conversion.* Additionally, if, despite existing precedent, the conversion of the grantor trust to a non-grantor trust at the grantor’s death is considered to be a taxable event, Treasury Regulation § 1.691(a)-2(b), Example 4 suggests that this taxable event would not produce IRD so long as it is viewed as occurring after the grantor’s death, and not in the moments before death. In Example 4, the proceeds of a buy-sell agreement that was contractually entered into before the decedent’s death, but that is not consummated until immediately after the decedent’s death, are not IRD.

c. *Estate of Peterson v. Commissioner.* The Tax Court has relied on these Regulations in finding that a sale does not result in IRD where the sale is effective “only upon the decedent’s death”.¹⁸² Because a grantor trust’s conversion to non-grantor trust occurs only at and after the grantor’s death, and not before, the grantor’s death should not trigger recognition of IRD from the continuing payments under the installment sale note.

d. *Character of Income.* Even if the installment sale payments were considered items of IRD, it is unlikely that such payments would be taxable. Section 691(a)(3) states that the character of the income in the hands of the beneficiary is the same as the character in the hands of the decedent, had he lived. Given that the grantor trust treatment would have continued had the grantor lived, payments from the grantor trust to the grantor would have continued to be non-taxable. Thus, if the grantor’s estate or its beneficiary is entitled to the same income tax treatment as the grantor

¹⁷⁹ H. Rep’t No. 107-84, 107th Cong., 1st Sess. 113 (2001).

¹⁸⁰ 84 T.C. 667 (1985); *see also* Treas. Reg. § 1.1001(c), Example (5) and Rev. Rul. 77- 402, 1977-2 C.B. 222.

¹⁸¹ I.R.C. § 691.

¹⁸² *Estate of Peterson v. Comm’r*, 74 TC 630 (1973).

during his lifetime, it follows that the installment sale payments made to the grantor's estate or its beneficiary are also non-taxable for income tax purposes.

3. Trust's Basis in Purchased Assets

Once a trust ceases to be a grantor trust, it is necessary to compute the basis of the assets on either side of the installment sale transaction – both the estate's basis in the installment sale note and the grantor trust's basis in the purchased assets. The estate's basis in the installment sale note is discussed, *infra*. For the assets purchased by the grantor trust, the proper starting point is Section 1012.

a. Section 1012 states the applicable default rule that a taxpayer's basis in each purchased asset is equal to such asset's cost basis, "except as otherwise provided." Thus, the grantor trust would take a basis in each purchased asset equal to the purchase price it paid for such asset under the installment sale contract (generally considered to be the aggregate of the note payments made to date), unless an exception applies.

b. Two Exceptions to Default Rule. There are two possible exceptions to this default rule, found at Sections 1014 and 1015.¹⁸³

(1) Section 1014. The first exception arises under Section 1014, which provides for a stepped-up basis in the case of property acquired from a decedent. Some commentators believe that, because there is a deemed "transfer" from the grantor to the newly-converted non-grantor trust at the grantor's death, the trust has "acquired the property from a decedent" and, thus, is eligible for a stepped-up basis under Section 1014.

(a) The weakness in this theory is that only ten forms of property are considered to have been acquired from, or to have passed from, a decedent for purposes of Section 1014. These forms are listed in Section 1014(b).

(b) Property received by a newly-converted non-grantor trust through a deemed transfer at the grantor's death is not clearly described in Section 1014(b), thus, Section 1014 is unlikely to apply to this type of transfer in general (and to the purchased assets in particular).

(2) Section 1015. Assuming Section 1014 does not apply to determine a trust's basis in purchased assets, the other exception to Section 1012 is Section 1015. Section 1015(a) sets forth the well-known rule that a donee takes the donor's basis in gifted property.

(a) However, Section 1015(a) should not apply to a sale for full and adequate consideration, as subsection (a) is meant to cover gifts only.

(b) Section 1015(b) is the more appropriate provision, which provides that property acquired "by a transfer in trust (other than ... by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor, increased by any gain (or decreased by any loss) recognized to the grantor upon such a transfer.

c. Section 1015(b) Analysis. Since the grantor trust acquired the purchased assets through a transfer in trust and the grantor recognized no gain or loss on the transfer, an analysis under 1015(b) leads to the conclusion that the trust took the grantor's basis in the purchased assets.

d. Doctrine of Consistency. Moreover, if one takes the position that the grantor's death did not trigger an income tax event to the grantor or his estate with respect to the purchased assets, it is consistent to conclude that his death will not change the grantor trust's pre-existing basis in such assets.¹⁸⁴

B. Aragona Trust and Selection of Trustees

After the enactment of the net investment income tax ("NIIT") under Section 1411, trustees of trusts owning real estate investments wondered whether the NIIT would apply to trust income derived from an active trade or business.

¹⁸³ See I.R.C. §§ 1014 and 1015.

¹⁸⁴ See, e.g., Ron Aucutt, *Installment Sales to Grantor Trusts*, 4 BUS. ENTITIES, No. 2, 28 (2002); Laura Peebles, *Death of an IDIT Noteholder*, 144 TR. & EST. NO. 8 (2005).

1. Net Investment Income Tax Problem

Section 1411(a)(1) imposes a 3.8% Medicare contribution tax on the *lesser* of (a) net investment income or (b) the excess of modified adjusted gross income over \$200,000 for other taxpayers, including single individuals. These limits are not adjusted for inflation. Thus, if a trust could prove it had very little to no net investment income, but rather income solely derived from an active trade or business, it would avoid the 3.8% NIIT.

Stated another way, trustees have sought guidance on how a trust could meet the material participation rules of Section 469. If the material participation test is met, then the trust's income is active and not considered net investment income. Because many trusts own interests in businesses that generate significant income, the question of whether that business income received by the trust is subject to the additional 3.8% tax can be quite significant. Further, if the material participation test is met, the trust could deduct losses under Section 469 as a real estate operator, as discussed in Article IV, *supra*.

2. Material Participation of Trusts

The Treasury Department has not drafted rules clarifying when a trust or estate has materially participated in a business, despite reserving Temporary Regulations to do so.¹⁸⁵ While a trustee's active participation will characterize the activity as non-passive, it is unclear whether the activities of a trustee's agents factor into the material participation analysis. Until the Treasury issues definitive guidance, this question will remain unresolved.

a. Mattie K. Carter Trust. In *Mattie K. Carter Trust v. U.S.*,¹⁸⁶ the District Court concluded that the activities of a trust's employees and agents—in addition to those of its trustees and fiduciaries—are relevant to the material participation analysis. The facts in *Carter* focused on the Carter Trust's operation of a large cattle ranch in central Texas. The trustee made most of the ranch's business decisions, but hired a full-time ranch manager and other employees to perform day-to-day tasks on the property. When the Carter Trust deducted ranch losses as non-passive losses, the IRS disallowed them, claiming that under Section 469(h)(1) "the material participation of a trust in a business should be made by reference only to the trustee's activities." The district court disagreed, determining that the activities of the Carter Trust's agents were sufficiently regular, continuous, and substantial to constitute material participation for the purposes of Section 469.

b. I.R.S. Tech. Adv. Mem. 200733023 (Aug. 17, 2007). Not surprisingly, the IRS rejected *Carter*, finding that the only way to establish material participation is by showing that a trust's "fiduciaries are involved in the operations of [a] business on a regular, continuous, and substantial basis."¹⁸⁷ In Technical Advice Memorandum 200733023, the IRS considered a trust's appointment of special trustees to perform specified financial and tax-related functions for the trust. Although the trustees relied on reports and advice provided by the special trustees, the special trustees could not make decisions legally binding the trust. Citing legislative history, the IRS concluded that the activities performed by the special trustees were irrelevant to the question of whether the trust materially participated in the business, and that only the actions of trust fiduciaries should be considered.¹⁸⁸

c. PLR 201029014. Then in a private letter ruling, the IRS held that "the sole means for a trust to establish material participation is if its fiduciary is involved in the operations of the activity on a regular, continuous, and substantial basis."¹⁸⁹

3. Review of *Aragona Trust*

In *Frank Aragona Trust v. Comm'r*, the Tax Court was confronted for the first time since the enactment of Section 1411 with the question of whether a trust can materially participate in an active rental real-estate activity.¹⁹⁰ The decision at issue was relative in determining whether the trust had active income and losses or passive income and loss.

a. Holding. In *Aragona Trust*, the Tax Court determined that a trust that owned real estate and engaged in other real estate activities qualified for the Section 469(c)(7) exception for real estate professionals. As a

¹⁸⁵ See Treas. Reg. § 1.469-5T(g).

¹⁸⁶ 256 F. Supp. 2d 536 (N.D. Tex. 2003).

¹⁸⁷ See TAM 200733023 (Aug. 17, 2007).

¹⁸⁸ See also S. Rep. No. 99-313, at 735 (1986) ("An estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating.").

¹⁸⁹ PLR 201029014 (July 23, 2010).

¹⁹⁰ 142 T.C. 165 (2014).

consequence, the trust was not subject to the passive activity loss limitations. In so concluding, the Court found that services performed on behalf of a trust may be considered personal services performed by the trust. The facts of *Aragona Trust* are somewhat unique and, therefore, its application could be more narrowly construed prospectively.

b. Trust Formation and Trustees. In 1979, Frank Aragona formed the trust as grantor and appointed himself as trustee, naming his five children as beneficiaries. According to the trust instrument, the five children share equally in the income of the trust. Frank Aragona died in 1981. He was succeeded as trustee by six individuals:

- (1) Paul V. Aragona. Executive Trustee and full-time employee of Holiday Enterprises, LLC.
- (2) Frank S. Aragona. Full time employee of Holiday Enterprises, LLC.
- (3) Anette Aragona Moran. Full time employee of Holiday Enterprises, LLC.
- (4) Salvatore S. Aragona. A full-time dentist whose involvement with the Trust was limited.
- (5) Anthony F. Aragona. A disabled individual whose involvement with the Trust was limited.
- (6) Charles E. Trumbull. Independent Trustee and attorney whose involvement with the Trust was limited.

c. Governance. Although the trustees formally delegated their powers to the executive trustee (in order to facilitate daily business operations), the trustees acted as a management board for the trust and made all major decisions regarding the trust's property. During 2005 and 2006 the board met every few months to discuss the trust's business. Each of the six trustees was paid a fee directly by the trust (referred to here as a "trustee fee" or collectively as "trustee fees") in part for the trustee's attending board meetings.

d. Holiday Enterprises, LLC. The trust owned Holiday Enterprises, LLC, a Michigan LLC that was wholly owned by the trust and was treated as a disregarded entity. Holiday Enterprises, LLC, managed most of the trust's rental real-estate properties. It employed several people in addition to Paul, Frank and Annette, including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks. In addition to receiving a trustee fee, Paul, Frank and Annette each received wages from Holiday Enterprises, LLC.

e. Real Estate Assets. The trust conducted some of its rental real-estate activities directly, some through wholly owned entities, and the rest through entities in which it owned majority interests and in which Paul and Frank owned minority interests. It conducted its real-estate holding and real-estate development operations through entities in which it owned majority or minority interests, and in which Paul and Frank owned minority interests.

f. Losses. During the 2005 and 2006 tax years, the trust incurred losses from its rental real-estate properties. The losses were reported on the trust's income-tax returns. Some of the losses were reported as being associated with Holiday Enterprises, LLC, including \$302,400 in trustee fees. The losses reported as being associated with Holiday Enterprises, LLC, were subdivided into various categories of expenses; the \$302,400 was reported in the category of "other" expenses. On its returns the trust treated its rental real-estate activities, in which it engaged both directly and through its ownership interests in a number of entities, as non-passive activities. So treated, the losses from these activities contributed to the amounts of net operating losses, which the trust carried back to its 2003 and 2004 tax years.

g. Notice of Deficiency. The IRS issued a notice of deficiency determining that the Trust's rental real estate activities were passive activities, which increased the Trust's passive activity losses for 2005 and 2006. This, in turn, resulted in a decrease in the allowable deductions from gross income for each of those years, which decreased the net operating loss carrybacks to the 2003 and 2004 tax years.

h. Section 469(c). Under Section 469(c)(2), any rental activity is considered a passive activity, even if the taxpayer materially participates in the activity. Thus, any rental activity is passive per se. In 1993 Congress enacted section 469(c)(7), which provides that section 469(c)(2) does not apply to the rental real-estate activity of any taxpayer who meets the requirements of section 469(c)(7)(B) as a qualifying real estate professional. A taxpayer qualifies

as such for a particular tax year if: (1) more than half of the personal services that he performs during that year are performed in real property trades or businesses in which he materially participates; and (2) he performs more than 750 hours of services during that tax year in real property trades or businesses in which he materially participates.¹⁹¹

i. Trusts as Qualifying Taxpayers? The regulations construing Section 469(c)(7) provide that only a "qualifying taxpayer" falls within the exception.¹⁹² A "qualifying taxpayer," in turn, is defined as "a taxpayer that owns at least one interest in rental real estate and meets the requirements of [Reg. § 1.469-9(c)]."¹⁹³ Reg. § 1.469-9(c) states that, in addition to owning at least one interest in rental real estate, a qualifying taxpayer must also satisfy the requirements of Section 469(c)(7)(B). The regulation further provides that "personal services means any work performed by an individual in connection with a trade or business."

j. Analysis. The Court began its analysis by looking at the function of a trust -- namely, an arrangement whereby trustees manage assets for the trust's beneficiaries. It concluded that if the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered "work performed by an individual in connection with a trade or business."¹⁹⁴ Accordingly, it concluded that a trust is capable of performing personal services and therefore can satisfy the Section 469(c)(7) exception. The Court noted that, had Congress wanted to exclude trusts from the exception, it could have done so by explicitly limiting the exception to "any natural person," which is the language used in Section 469(i) for landlords. The Court then determined that the trust materially participated in its real estate operations and thus qualifies for the exception. The Court concluded that the activities of the trustees, including their activities performed as employees of Holiday, should be considered in determining whether the Trust materially participated. Thus, the Court took into account the activities of all six trustees in their roles as trustees and as employees of Holiday (which constituted full-time participation in the Trust's real estate operations). It also found that the Trust's real estate operations were substantial and that the trustees handled practically no other businesses on behalf of the Trust. Finally, the Court found that the Trust's rental real estate activities were not passive activities.

k. Distinguished from *Mattie K. Carter Trust*. The *Aragona Trust* case can be distinguished from *Mattie Carter* in that the Tax Court specifically declined to address whether the activities of non-trustee agents could be considered for purposes of the real estate professional exception to the passive activity loss rule. *Mattie Carter*, as noted above, dealt with the activities of agents hired by the trustee to perform ranching and farming activities. The court concluded that the activities of the trustees, including their activities as employees, should be considered in determining whether the trust materially participated in real estate operations. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity wholly owned by the trust. Therefore, the trustees' activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

C. Uniform Principal and Income Act Issues

The Uniform Principal and Income Act (amended 2008) or "UPAIA" has been adopted in some form by all but a handful of states¹⁹⁵ and deals with four primary questions affecting the rights of beneficiaries:¹⁹⁶

- How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?
- When an income interest in a trust begins, due to the grantor's death or an *inter vivos* transfer into a new trust), what property is principal that will eventually go to the remainder beneficiaries and what is income?
- When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?
- After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or

¹⁹¹ I.R.C. § 469(c)(7)(B).

¹⁹² Treas. Reg. § 1.469-9(e)(1).

¹⁹³ Treas. Reg. § 1.469-9(b)(6).

¹⁹⁴ Reg. § 1.469-9(b)(4).

¹⁹⁵ Some states that have not adopted the UPAIA are Illinois, Georgia, Louisiana, and Rhode Island, according to www.uniformlaws.org.

¹⁹⁶ UNIF. PRINCIPAL & INCOME ACT § Prefatory Note (amended 2008).

between principal and income?

The UPAIA, in the form adopted by each state, provides a set of default rules for trusts administered in that state, but these default rules can be overridden by the trust agreement. Thus, in determining whether to allocate an item to income or principal or both, the first step is to review the trust agreement. If it is silent, then turn to the applicable state's version of the UPAIA. This section discusses a few issues arising under the UPAIA with respect to trust-owned real estate.

1. Rental Income

Under UPAIA Section 405, receipts of rent are allocated to income, including amounts received for the cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is pre-paid rent is allocated to principal. This amount is held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations are satisfied with respect to that amount.

If improvements have been made to the rental property, it may be appropriate to allocate a portion of the rental receipts as a reimbursement of those principal expenditures. In this case, a transfer from income to reimburse principal is permissible under UPAIA Section 504 to the extent that some of the "rent" is really a reimbursement for improvements.

2. Partnership Distributions

UPAIA Section 401 explains how to treat distributions from an entity, including a partnership, limited liability company, and real estate investment trust. UPAIA Section 401 does not apply to money received from a co-tenancy in property.

The general rule is that money received from an entity is allocated to income, and property received from an entity is allocated to principal.

When the trust's interest in the entity is liquidated, the money received is allocated to principal. Likewise, if the entity is fully or partially liquidating, the money received in the liquidating distribution is also allocated to principal. A partial liquidation occurs when:

- a. The distribution is accompanied by an indication from the entity that the distribution is a partial liquidation; or
- b. The total amount of money received in a distribution or series of related distributions is greater than 20% of the entity's gross assets, as shown by the entity's year-end financial statements for the year preceding the year of the initial receipt.
- c. Nevertheless, to the extent the money received is less than or equal to the amount of income tax the trustee must pay on the taxable income of the distributing entity, the distribution is not considered a partial liquidation and the funds are allocated to income in order to pay the tax.

The comments to Section 401 discuss a situation where the entity makes a large cash distribution to its owners, but the distribution does not rise to the 20% level. This could arise in the event the entity had refinanced or otherwise borrowed a large sum of money secured by an asset of the entity and then made a significant distribution of the loan proceeds to the owners. In that case, the Trustee "after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal," as long as the adjustment does not interfere with a material purpose of the trust under Section 104(c).

3. Schedule K-1 Income from Partnership

- a. UPAIA Section 505 provides the framework for payment of income taxes.
 - (1) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.¹⁹⁷

¹⁹⁷ UNIF. PRINCIPAL & INCOME ACT § 505(a) (amended 2008).

(2) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.¹⁹⁸

(3) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid:

- (a) from income to the extent that receipts from the entity are allocated only to income
- (b) from principal to the extent that receipts from the entity are allocated only to principal
- (c) proportionately from principal and income to the extent that receipts from the entity are allocated to both income and principal; and
- (d) from principal to the extent that the tax exceeds the total receipts from the entity.¹⁹⁹

b. After applying the rules listed above, the trustee shall adjust income or principal receipts to the extent that the trust's taxes are reduced because the trust receives a deduction for payments made to a beneficiary.²⁰⁰

c. The Official Comment notes that when a trust owns an interest in a pass-through entity, such as a partnership or S corporation, it must report its share of the entity's taxable income regardless of how much the entity distributes to the trust. Whether the entity distributes more or less than the trust's tax on its share of the entity's taxable income, the trust must pay the taxes and allocate them between income and principal.

d. UPAIA § 505(c) requires the trust to pay the taxes on its share of an entity's taxable income from income or principal receipts to the extent that receipts from the entity are allocable to each. This assures the trust a source of cash to pay some or all of the taxes on its share of the entity's taxable income.

e. UPAIA Subsection 505(d) recognizes that, except in the case of an Electing Small Business Trust (ESBT), a trust normally receives a deduction for amounts distributed to a beneficiary. Accordingly, subsection 505(d) requires the trust to increase receipts payable to a beneficiary as determined under subsection (c) to the extent the trust's taxes are reduced by distributing those receipts to the beneficiary.

f. Interrelated Calculation. Because the trust's taxes and amounts distributed to a beneficiary are interrelated, the trust may be required to apply a formula to determine the correct amount payable to a beneficiary. This formula should take into account that each time a distribution is made to a beneficiary, the trust taxes are reduced and amounts distributable to a beneficiary are increased. The formula assures that after deducting distributions to a beneficiary, the trust has enough to satisfy its taxes on its share of the entity's taxable income as reduced by distributions to beneficiaries.

1. *Example 1* – Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$100,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c) T's tax must be paid from income receipts because receipts from the entity are allocated only to income. Therefore, T must apply the entire \$100,000 of income receipts to pay its tax. In this case, Beneficiary B receives nothing.

2. *Example 2* - Trust T receives a Schedule K-1 from Partnership P reflecting taxable income of \$1 million. Partnership P distributes \$500,000 to T, which allocates the receipts to income. Both Trust T and income Beneficiary B are in the 35 percent tax bracket. Trust T's tax on \$1 million of taxable income is \$350,000. Under Subsection (c), T's tax must be paid from income receipts because receipts from P are allocated only to income. Therefore, T uses \$350,000 of the \$500,000 to pay its taxes and distributes the remaining \$150,000 to B. The

¹⁹⁸ *Id.* at § 505(b).

¹⁹⁹ *Id.* at § 505(c) (amended 2008).

²⁰⁰ *Id.* at § 505(d).

\$150,000 payment to B reduces T's taxes by \$52,500, which it must pay to B. But the \$52,500 further reduces T's taxes by \$18,375, which it also must pay to B. In fact, each time T makes a distribution to B, its taxes are further reduced, causing another payment to be due to B.

4. Mortgages and Depreciation

Depreciation has always been a thorny issue under the UPAIA. Section 13(a)(2) of the 1962 Act provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles" That provision was resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business.

The Drafting Committee of the UPAIA concluded that the decision to provide for depreciation should be discretionary with the trustee. Therefore, under Section 503, the trustee has the power to transfer rental receipts from income to principal to cover depreciation. This power is a "discretionary power of administration" and as such, a trustee must comply with UPAIA Section 103(b) in exercising the power. UPAIA Section 103(b) is a general provision requiring the trustee, in exercising discretion under the UPAIA, to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries."

One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of a mortgage or other indebtedness secured by the depreciable property. UPAIA Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments on the mortgage.

Section 503 states:

a. In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

b. A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

(1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;

(2) during the administration of a decedent's estate; or

(3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

c. An amount transferred to principal need not be held as a separate fund.

5. Unproductive Property

Typically, proceeds from the sale or other disposition of real estate are principal without regard to the amount of income the asset produces during any accounting period. One exception to this rule arises with respect to marital deduction property.

If a trust that qualified for the marital deduction does not provide the surviving spouse with sufficient income from the trust assets, and if, after making an equitable adjustment under UPAIA Section 104, the amounts that the trustee transfers from principal to income and distributes to the spouse are still insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or make an equitable adjustment under UPAIA Section 104(a).

Once the two conditions have occurred – insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section – the trustee must act. The trustee may either make the property productive of a reasonable income, sell the unproductive property, transfer funds from principal to income, or to take some combination of

these actions. The trustee may rely on the power to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property.

The language found in the statute draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a surviving spouse to qualify for a marital deduction if applicable state law is unclear about the surviving spouse's right to compel the trustee to make property productive of income.

VIII. SECTION 754 ELECTION

The essence of the election under Section 754 (the "754 Election") is to marry a partner's inside basis and outside basis.

- "Inside basis" refers to the basis a partnership holds in its assets, and how that basis is reflected in the partners' capital accounts.
- "Outside basis" refers to the basis of the partnership interest in the hands of the partner, and how that basis is reflected in the partner's own books and records.

A. Overview of the Election

1. Adjustment to Outside Basis

A partner's outside basis is determined by Section 722 upon the formation of the partnership. In the case of a substituted partner who buys an interest from a withdrawing partner, the outside basis is governed by Section 1012. Upon the death of the partner, Section 1014 controls.

Sections 1014(a)(1) and 1014(c) provide that, upon a partner's death, his outside basis in the partnership interest is equal to the interest's fair market value as of the decedent's date of death or the alternate valuation date (if applicable), less any income in respect of a decedent associate with the partnership interest. In addition, the recipient's holding period for purposes of determining long term gains versus short term gains is deemed to be more than one year.²⁰¹

2. Adjustment to Inside Basis

If a 754 Election is in effect, the deceased partner's inside basis is adjusted upwards or downwards to match the partner's outside basis, in the manner provided in Section 743(b). Any adjustment to basis made pursuant to Section 743(b) is made with respect to the transferee partner only, and not to all of the other partners in the partnership. If the 754 Election results in an increase in the deceased partner's inside basis, then the successor in interest to the deceased partner (the "successor partner") should have less gain than the other partners in the event of a later sale for a profit, or a larger share of the loss than the other partners. In addition, a basis increase allows the successor partner to claim higher depreciation deductions than the other partners as a result of his or her higher inside depreciable basis.

The increase or decrease in inside basis is allocated to the affected partner's share of each asset of the partnership, on a pro rata basis.²⁰² Reg.

3. Downsides to the 754 Election

While the 754 Election sounds straightforward and harmless, there are many downsides²⁰³:

- a. The recordkeeping of maintaining different basis adjustments to the capital accounts of different partners is burdensome.
- b. If partnership assets are worth less than their basis at the partner's death, the 754 Election causes a step-down in basis, which will increase the successor partner's gain after a later liquidity event. The basis step-

²⁰¹ I.R.C. § 1223(9).

²⁰² Treas. Reg. § 1.755-1(b)(3)(iii), Example 2.

²⁰³ For an excellent discussion of the 754 Election and a decision tree outlining when to make and not make the election, see Carol A. Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES (2013).

down is a particular risk where valuation discounts are taken on a minority partnership interest at the deceased partner's death.

c. The election is irrevocable without the consent of the IRS, and the IRS does not typically grant consent unless there is a business purpose for the revocation other than tax savings.

d. Once the election is made, it applies to all future tax years unless the IRS grants a revocation. This means the election applies at the deaths of all other partners, whether it would be beneficial to that partner's heirs or not. In addition, once the 754 Election is in effect, it also applies to adjust the inside basis of the partnership when certain types of distributions are made under I.R.C. 734(b).

Carol Cantrell offers this helpful advice:

Unless the § 754 election will produce significant short-term benefits, it should probably not be made because of its impact on the remaining partners. For example, if the partnership redeems the estate shortly after death, the estate will fully utilize its outside basis in calculating its gain or loss with no need for the inside step-up afforded by the election. Or if the partnership does not plan to sell any of its major assets anytime soon, a step-up on the inside basis from the § 754 election does not produce any immediate tax savings. In both cases, if the partnership had made the election, it might have wasted it for little or no benefit, while causing significant impact on the remaining partners for the duration of the partnership. So in cases like these where the estate's interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. Whether or not to make the election is one of the hardest decisions a partnership can make.²⁰⁴

B. Mechanics of the Election

1. Making the Election

The 754 Election can be made in a tax year in which one of the following circumstances occurs²⁰⁵:

- a. A distribution of property is made to a partner.
- b. A partner dies.
- c. There is a transfer of a partnership interest by sale or exchange.

If the election is not made for the year in which the partner dies, it could also be made in the year the estate's interest is distributed to the successor partner, as this should be treated as a sale or exchange pursuant to Section 761(e).

A partnership makes the 754 Election by attaching a written statement, signed by any one of the partners, to its timely filed return (including extensions thereof) for the year in which the partner died or the transfer occurred.²⁰⁶ There is an example of a written statement to be submitted at Treas. Reg. 1.754-1(b)(2). The partnership should also check the box on line 12a of Form 1065, Schedule B, indicating that it is making the election. If the partnership is multi-tiered, with parent and subsidiary entities, the 754 Election must be made at each level.²⁰⁷

2. Late Elections

The 754 Election is eligible for an automatic 12-month extension from the due date of the partnership return (with extensions).²⁰⁸ The partnership return, with extensions, is due by September 15th, so this gives the partnership until September 15th of the second year after the partner's death to decide whether to make the 754 Election. To take advantage of this extension, the partnership should state: "FILED PURSUANT TO §301.9100-2" at the top of its filing, and send it to the

²⁰⁴ *Id.*

²⁰⁵ I.R.C. § 734(b).

²⁰⁶ Treas. Reg. § 1.754-1(b).

²⁰⁷ Rev. Rul. 87-115, 1987-2 C.B. 163.

²⁰⁸ Treas. Reg. § 301.9100-2(a)(2)(vi).

same address as the filing to make the election would have been sent had the filing been timely made. User fees do not apply.²⁰⁹

If the partnership fails to make the 754 Election during the 12-month period for automatic extensions, it may still request a late 754 Election under Treas. Reg. § 301.9100-3. Relief may be granted in the IRS's discretion, and only if the partnership acted reasonably and in good faith and the relief does not jeopardize the interest of the government. The IRS has been generous in granting relief for late 754 Elections where the failure was inadvertent.

Examples of acting reasonably and in good faith include:

- a. Complications of administering the estate;²¹⁰
- b. Extended litigation;²¹¹
- c. Reliance on accountants who made an error or failed to properly inform them;²¹²
- d. Preparation of the election statement, but failure to attach it to the return;²¹³ and
- e. Simple inadvertent failure, where the taxpayer acted in good faith.²¹⁴

While the IRS forgives many late filed elections, the process requires a \$10,000 user fee (\$2,000-\$4,000 for small taxpayers) and takes months to complete.²¹⁵

3. Revoking the Election

The 754 Election is irrevocable unless a revocation is approved by the district director for the internal revenue district in which the partnership return is required to be filed. To request a revocation of the 754 Election, a partner must file an application setting forth the grounds on which the revocation is desired. The application must be filed not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect, and must be signed by any one of the partners.

Examples of situations that give rise to a revocation include²¹⁶:

- a. A change in the nature of the partnership business
- b. A substantial increase in the assets of the partnership
- c. A change in the character of partnership assets, or
- d. An increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election.

The Regulations clearly state that no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.²¹⁷

C. Mandatory Basis Adjustment

in 2004, Section 743(a) was amended by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, § 833, to require a basis adjustment "if the partnership has a substantial built-in loss immediately after such transfer." This

²⁰⁹ Treas. Reg. § 301.9100-2(d).

²¹⁰ See, e.g., PLR 200531016 (Aug. 5, 2005); PLR 200530015 (July 29, 2005).

²¹¹ See *id.*

²¹² See, e.g., PLR 201012031 (Mar. 26, 2010); PLR 200906026 (Feb. 6, 2009); PLR 200530018 (Apr. 15, 2005).

²¹³ See, e.g., PLR 200802001 (Sept. 20, 2007).

²¹⁴ See, e.g., PLR 201122011 (Feb. 10, 2011); PLR 201119020 (Feb. 1, 2011); PLR 201122015 (Jan. 18, 2011).

²¹⁵ Rev. Proc. 2017-1, 2017-1 I.R.B. 1.

²¹⁶ Treas. Reg. § 1.754-1(c)(i).

²¹⁷ *Id.*

language means that the death of a partner could result in a downward adjustment to the partnership's inside basis if, immediately after the partner's death, the partnership has substantial built-in loss.

1. Substantial Built-In Loss

“Substantial built-in loss” is defined by Section 743(d)(1) to mean that the basis of the partnership assets exceeds the fair market value of those assets by more than \$250,000. This amount is not adjusted for inflation, meaning the mandatory rules will be triggered with greater frequency as a result of inflation.

The \$250,000 threshold is judged based on all of the assets in the partnership in the aggregate, and not on an asset by asset basis. The partnership must determine whether the threshold has been met at the partnership level first, and then adjust the deceased partner's basis once the determination has been made.

Also, unlike the 754 Election, the mandatory basis adjustment is applied based on the difference between the basis and fair market value of the partnership property, not the partnership interest at issue. However, once the \$250,000 threshold is met, the mandatory adjustment is made based on the difference between the inside basis and the discounted (fair market) value of the partnership interest at issue, which could compound the downward basis adjustment to the deceased partner's inside basis.

Example²¹⁸: ABC is a partnership which does not have a 754 Election in effect. ABC has no liabilities. The fair market value of ABC's assets is \$4 million and the adjusted basis of ABC's assets is \$4.3 million. ABC has a substantial built-in loss because the adjusted basis of the partnership property exceeds the fair market value of the partnership property by more than \$250,000. A, a partner of ABC, dies, and the fair market value of her 25% partnership interest in ABC is reported at \$700,000 on the estate tax return (\$4 million x 25% less a 30% discount). Under Section 743(b), an adjustment is required to the adjusted basis of ABC's assets with respect to the interest owned by A's estate. The partnership interest will receive a downward basis adjustment of \$375,000 (25% x \$4,300,000 less \$700,000), which will be applied to each asset owned by ABC on a pro rata basis.

An estate or its beneficiary must provide written notice of the partner's death or the transfer to the partnership within one year of the death of the deceased partner, and the partnership must attach the statement described in Treas. Reg. § 1.743-1(k)(2)(ii) to the partnership return for the year of the partner's death.

The basis adjustment resulting from the substantial built-in-loss rules is not a permanent election like the 754 Election. It applies only for the year in which the transfer occurred or the decedent died where there was also a substantial built-in-loss.

2. Planning Opportunities

If a partnership has a built-in loss exceeding \$250,000, and the death of a major partner is imminent, there are a few planning options available:

a. The partnership could sell the asset that generates the built-in loss before the partners dies, allowing the partners to recognize losses.

b. The ill or elderly partner could gift of all or a portion of his partnership interest to a family member to transfer his built-in losses to the donee under Section 704(c). However, this is only viable if the property was contributed to the partnership before October 22, 2004.²¹⁹

c. If the partnership has one asset that has appreciated significantly in value and another that has declined significantly in value as compared to its basis, the partnership could restructure and spin-off the sinking asset to a separate partnership.

²¹⁸ Derived from I.R.B. 2005-32, 2005-1 C.B. 895 (April 1, 2005).

²¹⁹ I.R.C. § 704(c)(1)(C), added by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 § 833.

D. Special Issues Regarding the Election

1. Community Property

In community property states, if one spouse to the marriage dies owning a partnership interest that is treated as community property, one-half of the value of that interest will be included in the deceased partner's estate. Rev. Rul. 79-124²²⁰ makes clear that, when a 754 Election is in effect, the basis adjustment will be made to the deceased partner's entire partnership interest, not just the one-half interest included in his estate. The same would be true if the non-partner spouse died first and had to include one-half of the community property interest in the partnership in her estate. Her husband's entire partnership interest would receive a basis adjustment.

2. QTIP Property

When a QTIP trust includes a partnership interest at the surviving spouse's death, there is no clear guidance as to whether the partnership may make a 754 Election based on the surviving spouse's death.

a. Conservative View. Some commentators suggest the election cannot be made because the partner (the QTIP trust) has neither sold, transferred, distributed its interest or died, which are prerequisites for the QTIP trust to adjust its share of the inside basis of partnership property under Section 754.²²¹

(1) Even if that is the case, the 754 Election should be able to be made once the QTIP trust transfers its interest in the partnership to the residual beneficiaries, as such a transfer should be considered a sale or exchange under Section 761(e).

(2) If the partnership takes this conservative view that the 754 Election is not permitted at the QTIP beneficiary's death, and relies on a distribution to the QTIP residuary beneficiaries to trigger the 754 Election, such distribution should be made as soon as possible after the surviving spouse's death so that a second appraisal is not needed to re-determine fair market value of the transferred partnership interest.

b. Another Reasoned View. Other commentators argue that the surviving spouse's death should give rise to an opportunity for a 754 Election.²²² The partnership interest will be included in the surviving spouse's gross estate under Section 2044, and Section 2044 treats such property as "passing from the decedent". In addition, Section 1014(b)(10) treats property includible in the gross estate of the decedent under Section 2044 as having "passed from the decedent" for purposes of acquiring an adjusted basis equal to fair market value on the decedent's date of death. Given that the partnership interest is included in the surviving spouse's gross estate under Section 2044 and is treated as "passing from the decedent" to the residuary beneficiaries of the QTIP trust, the partnership should be able to make a 754 Election.

(1) If the QTIP trust's outside basis is much higher than the inside basis of the partnership assets allocable to the trust, then the trustee of the QTIP trust should consider requesting that the partnership make the 754 Election.

(2) Applying the doctrine of consistency, if a partnership interest is included in a QTIP trust at the surviving spouse's death, and the partnership has a substantial built-in loss of more than \$250,000, the mandatory basis adjustment rules should apply with respect to the QTIP trust's partnership interest under Section 743(b).

3. IRS Audit of Estate Tax Return

If the estate is taking an aggressive position with respect to valuation discounts for the partnership interest and an IRS audit of the estate tax return is expected, it may be hard to determine whether to make the 754 Election. If the IRS adjusts the discount down and thus increases the value of the partnership interest to the point where its fair market value exceeds the inside basis, the estate or its beneficiaries may prefer to have the 754 Election in place. In this situation, it is better to err on the side of not making the 754 Election, as the IRS has been generous in granting relief for late elections.

²²⁰ Rev. Rul. 79-124, 1979-1 C.B. 224.

²²¹ Frank J. O'Connell and Sally E. Day, *Marital Trusts and the Sec. 754 Election*, THE TAX ADVISER MAGAZINE, TAX CLINIC, 9-06 T.T.A. 514 (Sept. 2006), cited by Carol A. Cantrell in *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES (2013).

²²² Carol A. Cantrell, *Income Tax Problems When the Estate or Trust is a Partner*, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES (2013).

The deceased partner's estate or successor partner has the following options for making the 754 Election after the IRS audit is complete:

- a. File for an automatic extension of time to make the 754 Election under Treas. Reg. 301-9100-2 if the IRS audit is complete by September 15th of the second year following the year the estate transferred the interest to the successor partner.
- b. File a request for relief under Treas. Reg. 301-9100-3 and pay the user fee if it can be shown that the partnership acted reasonably and not solely on the basis of hindsight.
- c. The successor partner may be entitled to equitable relief if the statute of limitations period has expired.

4. Section 2036 Estate Inclusion

a. PLR 200626003. In PLR 200626003, a taxpayer transferred a 1/4 tenant in common interest in real estate to each of his three children and retained a 1/4 interest for himself. Later, the taxpayer and his three children contributed the real estate to an LLC in exchange for 25% LLC interests. At the time of the taxpayer's death, he was receiving 100% of the income from the LLC. As a result, 100% of the value of the LLC was included in the taxpayer's estate under Section 2036.

(1) The taxpayer's Will distributed his 25% LLC interest to his three children, in equal shares. The LLC did not make a 754 Election on its partnership return for the year of the taxpayer's death. The stated reason was that, although the LLC and its partners were aware of the election, the benefit it provided to the 25% interest did not outweigh the complexity of creating multiple bases.

(2) After the audit included the entire value of the real estate in the taxpayer's estate, the LLC requested permission to make a late 754 Election under Treas. Reg. 301.9100-3. The request was denied because Treas. Reg. 301.9100-3(b)(3)(iii) provides that the taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief.

(3) Nevertheless, the ruling did provide that because the actual real estate was included in decedent's estate under Section 2036, rather than the 100% LLC interest, the basis of the real estate was adjusted to fair market value and thus the LLC's inside basis was adjusted under Section 1014.

b. Jorgensen v. Commissioner. The Tax Court reached this same conclusion in *Jorgensen v. Commissioner* where partnership assets were included in the decedent's gross estate under § 2036.²²³ The assets brought back in to Erma Jorgensen's estate included partnership interests that had been gifted to other family members many years prior to her death. Shortly after her death, the partnership sold certain stocks for significant gain. The descendants of Erma Jorgensen, who had owned their partnership interests for around 10 years at that point, reported the gain. Once the gifted partnership interests were brought back into the estate, the other partners requested, and the Tax Court granted, relief under the doctrine of equitable recoupment in Section 6214(b). This allowed the other family members to step up the inside basis of partnership assets and reduce the gains they had previously reported, even though the statute of limitations period had closed.

5. Summary of When to Make and Not Make the 754 Election

a. When 754 Election Should Be Made.

(1) The FMV of the partnership assets on the date of death is greater than their cost basis, even after applying valuation discounts, and the estate's interest in the partnership is significant.

(2) The FMV of the partnership assets on the date of death is greater than their cost basis, and the partnership plans to sell all or part of its assets soon after the partner's death.

b. When 754 Election Should NOT Be Made.

²²³ *Jorgensen v. Comm'r, T.C.* Memo 2009-66 (Mar. 26, 2009), *aff'd* 107 AFTR 2d 2011-2069 (9th Cir 2011).

(1) If the fair market value of the partnership assets on the date of death is less than their cost basis.

(2) If the inherent loss is more than \$250,000, you still would not make the election, but the mandatory basis rules of Section 743(b)(2) will require the partnership to adjust the decedent's share of basis in the partnership assets down to the discounted value of his partnership interest on the date of death, so that the estate or successor will not be able to claim the loss.

(3) If the estate's interest in the partnership is not significant, it is probably best to not make the election, to avoid the accounting burdens of varying basis accounts.

c. When to Extend the Partnership Return and Wait and See.

(1) The FMV of the partnership assets on the date of death is greater than their cost basis, but not after applying valuation discounts. In that case, wait and see if the IRS will adjust the discounted value of the partnership interest such that the value of the partnership interest is greater than the cost basis.

(2) The partnership can file a late 754 Election on an original or amended return, but this is only worthwhile if the estate's interest is significant and there has been or is likely to be a gain recognition event.