Borrowing Basis: Using the family limited partnership to transfer basis to an appreciated asset one intends to sell that can either eliminate reporting gain on its sale or defer the reporting of the gain

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Borrowing Basis: Using a partnership to transfer basis to an appreciated asset one intends to sell before death that can either eliminate reporting the gain on its sale or defer the reporting of that gain.

Rather than waiting for the income tax-free step-up in basis at death, individuals may prefer to sell an appreciated asset while they are living.

The first portion of today's presentation will describe the application of the partnership income tax principles used to shift basis from an asset one does not intend to sell to an appreciated asset one desires to sell in the future, thereby eliminating gain when that asset is eventually sold. Borrowing basis can also be used when the appreciated asset one would like to sell that is owned by a trust not exposed to estate taxes so that step-up in basis at death is not available.

The second portion of today's presentation will examine how borrowing basis can be used to defer the reporting of the phantom gain existing in appreciated real estate one intends to sell where mortgage liabilities exceed adjusted tax basis.

When basis is transferred to another asset, that creates potential gain in the asset from which the basis was transferred. A third objective of today's presentation will be to examine how to deal with the potential gain created in the asset that shifted its basis to another asset.

We will begin today by quickly reviewing the fundamental income tax principles we will be using and then illustrate the application of these principles to either shift the gain to another asset or defer the reporting of the gain to far in the future.

If there is time, we will discuss the Section 2701 preferred partnership freeze designed to obtain an income tax-free step-up in basis at death for encumbered real estate without exposing that portion of the value of the real estate encumbered by liabilities to the estate tax, while at the same time sheltering value not encumbered by liabilities from estate tax exposure using traditional estate freeze techniques.

Today's program has two primary objectives:

The first is to introduce you to these income tax planning techniques or refresh your understanding of these techniques.

The second, and perhaps the more practical objective of today's presentation, is to demonstrate how to communicate somewhat complex techniques in an understandable manner because the partnership income tax rules and the income tax principles for liabilities can be technically complex and can be difficult for a potential client to understand using tax terminology. I use simple to follow numerical examples so that one can visualize how the solutions work rather than just describing the technique using technical tax terminology.

I. Fundamental partnership income tax principles under § 732 when a partnership distributes an asset to a partner

Unlike a C or S corporation, when a partnership distributes an appreciated asset to a partner, none of the built-in gain is reported. In order to preserve the appreciation in value for future income tax reporting when an appreciated asset is distributed to a partner, the partnership's basis in the distributed asset carries over to the partner receiving the asset. The same carryover basis principle applies when an asset with a built-in loss is distributed to a partner.

General rule: When a partnership distributes an asset to a partner, the partner's basis in the asset received as a distribution is the same as the partnership's basis in the asset.

> **Example:** A's outside basis for A's partnership interest is $14,000. The value of A's partnership interest is $20,000 and represents a 20% interest in the partnership. The partnership distributes an appreciated capital asset to A with a value of $10,000 and a basis of $6,000, reducing A's partnership interest from 20% to 10%. Neither the partnership nor the partner realizes any gain upon a distribution of an appreciated asset. Therefore, all the income tax attributes inherent in the distributed asset are passed on to A, including holding periods and depreciation recapture potential.
>
> Because the partnership's basis for the distributed asset is passed on to A, A's outside basis for his partnership interest must be reduced by the basis A takes in the distributed asset. In effect, a portion of a partner's outside basis is shifted to the distributed asset. Therefore, A's basis in the capital asset is $6,000. And, A's basis for his partnership is reduced by $6,000 to $8,000.

Exception 1: A partner's basis in a distributed asset cannot exceed that partner's basis for her partnership interest.

> **Example:** A's outside basis in her partnership interest is $4,000. The value of A's partnership interest is $20,000 and represents a 20% interest in the partnership. A receives as a liquidating distribution a capital asset with a $7,000 inside basis and a value of $20,000.
>
> The built-in gain inherent in A's partnership interest is $16,000. If A is permitted to take a $7,000 carryover basis for the distributed asset, the built-gain gain potential in the distributed asset would only be $13,000. To preserve the entire $16,000 built-in gain potential shifted from the partnership interest to the distributed asset, A's basis in the distributed asset is limited to the $4,000 of basis for A's partnership interest.

Therefore, \$3,000 of the basis in the asset distributed to A disappears. Using the § 754 election, § 734(b) provides that the \$3,000 of disappearing basis can be shifted back to the partnership and used by the partnership to increase the basis in the partnership's remaining assets.

Exception 2: If a partner's interest in the partnership is terminated by the receipt of a liquidating distribution, the partner's outside basis or his partnership interest is substituted as his basis for the distributed asset

Example: A's outside basis is \$12,000 for his 20% partnership interest, valued at \$20,000. A receives in complete redemption of A's partnership interest an asset with a basis of \$7,000 and a value of \$20,000. Because the built-in gain inherent in A's 20% interest is \$8,000, giving A a basis in the distributed asset of only \$7,000, would increase A's built-in gain from \$8,000 to \$13,000. Therefore, A's basis in the asset received is \$12,000. Because the distribution in complete redemption of A's partnership interest increased the basis to A in the distributed asset by \$5,000, § 734(b) requires that the inside basis for the partnership's remaining assets is decreased by \$5,000.

The fundamental income tax principle for exceptions to the general carryover basis rules under Section 732 is that it is needed to prevent the assignment of one partner's share of the appreciation in value of partnership assets to another partner.

Example: The ABC partnership is an equal three-partner partnership. A, B and C each contributed \$100,000 cash to the partnership for a 1/3 interest. The partnership invests its \$300,000 capital contribution in raw land at a cost of \$300,000. Several years later, the land increased in value to \$750,000. Therefore, \$450,000 of appreciation in value (the built-in gain) occurred while A, B and C were equal partners. The ABC partnership admits D as a 25% partner in return for D contributing \$250,000 cash to the partnership. As a 25% partner, D is entitled to 25% of all partnership profits. After D's capital contribution, the land increases in value and is then sold for \$850,000. Only \$100,000 of appreciation value occurred while D was a 25% partner. When the partnership sells the land for \$850,000, it reports a \$550,000 gain. If D was allocated 25% of the \$550,000 gain, a portion of the \$450,000 built-in gain that occurred while only A, B, and C were partners would be allocated to D. To prevent the assignment of a portion of A, B and C's built-in gain to D, the prohibition against assignment of income eared by one taxpayer to another taxpayer provides that the \$450,000 built-in gain must be allocated among A, B and C. Therefore, D is only entitled to 25% of the \$100,000 post admission gain.

II. Application of partnership income tax principles: Shifting basis from a high basis asset to an appreciated asset a partnership plans to sell

Current Status:

An existing family limited partnership owns appreciated marketable securities. As part of a successful estate plan, the 99% limited partnership interest is owned by a grantor trust. The partnership received capital contributions of its appreciated assets more than seven (7) years ago. Therefore, the mixing bowl rules under §§ 704(c)(1)(B) and 737 do not apply.

Partnership Balance Sheet

Asset	*Inside Basis*	*Value*	*Capital Accounts*	*Value*
CA #1	$1,000,000	$10,000,000	General Partner	-0-[1]
CA #2	$4,000,000	$10,000,000	Limited Partner Grantor Trust (Senior)	$30,000,000
CA #3	$8,000,000	$10,000,000		
	$13,000,000	$30,000,000		$30,000,000

Each Partner's Basis in their Partnership Interest

(outside basis)

General Partner	Grantor Trust
0	$13,000,000

Total built-in gain in the inside assets: $17,000,000

The partnership intends to sell its appreciated assets while Senior is living. First, step-up in income tax basis at death is not practical because the partnership interest is already owned by an irrevocable trust that is not exposed to the estate tax. And, it will not be practical for Senior to use the exchange power that created grantor trust status to return the appreciated assets to Senior for inclusion in Senior's gross estate. And, more importantly, step-up ion basis at death is not an alternative because the partnership intends to sell the appreciated assets while Senior is living.

[1] The general partner need not make a capital contribution. Instead, the general partner can receive only a profits interest for future services the general partner provides for the partnership.

Step 1: Since the limited partner is a grantor trust, the newly-admitted partner must be a tax person other than a Senior (the grantor). That other tax person can be Senior's spouse, a child or a complex trust.

Senior's spouse owns CA #4, acquired CA #4 as a gift from Senior, with a basis of $30,000,000 and a value of $30,000,000 (value is not relevant, need the basis). A spouse is a separate taxpayer for income tax purposes even though the spouses file a joint income tax return.

Senior's spouse contributes CA #4 to the FLP for a limited partnership interest.

Partnership Balance Sheet

Asset	*Basis*	*Value*	*Capital Accounts*	*Value*
CA #1	1,000,000	10,000,000	General Partner	-0-
CA #2	4,000,000	10,000,000	Grantor Trust (Senior)	30,000,000
CA #3	8,000,000	10,000,000	Senior's Spouse	30,000,000
CA #4	30,000,000	30,000,000		
	43,000,000	60,000,000		60,000,000

OUTSIDE BASIS

General Partner	Grantor Trust	Senior's Spouse
0	13,000,000	30,000,000

Step 2: Before the FLP makes any in-kind distributions to the grantor trust as a partial or complete redemption of its partnership interest (its capital account), the FLP must wait two years to avoid the § 707 disguised sales rules. There is also a need to wait at least two years so that it has less of an exposure to the partnership anti-abuse rules which look at whether the partnership was formed or *availed of* to use Subchapter K to do what cannot be done if done directly.

Step 3: After waiting for two years, the FLP distributes CA#4 to the Grantor Trust, reducing its capital account by the value of the distributed asset. The Grantor Trust's partnership interest can be terminated, or the Grantor Trust can remain as a partner. Assume the Grantor Trust's entire partnership interest is redeemed, and the Grantor Trust receives a liquidating distribution worth $30,000,000, the value of its capital account. The Grantor Trust's basis in the distributed asset is limited to the Grantor Trust's $13,000,000 basis in its partnership interest. Therefore, t*he Grantor Trust cannot take a basis in the distributed asset more than its outside basis*

Grantor Trust's Outside Basis	
13,000,000	
<13,000,000>	outside basis allocated to CA#4
0	

Therefore, $17,000,000 of basis has disappeared because the Grantor Trust's basis in CA#4 is limited to $13,000,000.

Because the FLP has a § 754 election in place, the $17,000,000 of disappearing basis can be allocated by the FLP among its remaining inside assets. Under § 755, the +$17,000,000 § 734(b) special basis adjustment is allocated only among the inside assets with appreciation in value as follows:

Partnership Balance Sheet

Assets	*Basis*	*§ 734(b)*	*Value*	*Capital Accounts*	*Value*
CA #1	1,000,000	+9,000,000	10,000,000	General Partner	-0-
CA #2	4,000,000	+6,000,000	10,000,000		
CA #3	8,000,000	+2,000,000	10,000,000	Senior's Spouse	30,000,000
	13,000,000	+17,000,000	30,000,000		30,000,000

After the application of the special basis adjustment, the partnership has increased its basis in CA #1, CA #2 and CA #3 to $10,000,000 each. The partnership can now sell any of its three assets for their $10,000,000 values and have no realized gain upon a sale.

The Grantor Trust now owns CA#4 with $17,000,000 of built-in gain, creating potential gain in CA#4 from this basis shift. Is there an asset where the Internal Revenue Code provides that the eventual realized gain in not subject to income taxes (*i.e.* excluded from gross income), especially because the assets in an irrevocable trust that is not exposed to estate tax cannot receive an income tax-free step-up in basis at death. Recall, that the Grantor Trust cannot obtain a step-up in basis at death because its assets will not be included in the grantor's gross estate when the grantor dies.

Rationale for not allowing the $17,000,000 of appreciation that occurred while the Grantor Trust was the partner to be shifted to a newly-admitted partner?

Application of the basis rules for distributions under § 732 prevents the Grantor Trust from shifting its potential gain to a newly-admitted patner. Furthermore, because Senior's spouse contributed as asset with a basis and a value of $30,000,000, the special basis adjustments under §734(b) are designed to make sure that Senior's spouse should not report the gain transferred to Capital Asset #4, now owned by the Grantor Trust. If the Grantor Trust took a $30,000,000 basis in Capital Asset #4, and Senior's spouse remained as a partner in a partnership with the three appreciated assets, the general carryover basis treatment would allow the shifting of $17,000,000 built-in gain to another partner. The exceptions to general carryover basis treatment are designed to prevent this assignment of income. Because the IRS cannot disregard the fundamental prohibition against assignment of income mandated in the basis rules under Section 732, it is bound by its application

The above example assumed the partnership had no other assets. Typically, a partnership will have other assets the partnership does not intend to sell in the near future, assets that have declined in value and other assets that may complicate the borrowing basis proposal. A practical solution is to use the partnership division rules under § 708 to separate the gain assets from the other assets. The partnership division basics will not be discussed in this paper as it would take most of an hour to cover the topic. Two former students, who were in my partnership tax class for their LL.M. degrees, co-authored a recent article on partnership divisions and how the partnership division rules can be used to separate the gain assets the partnership intends to sell from its other assets.[2]

[2] Yuhas and Radom, *Cutting-Edge Basis Planning: Paring Partnership Divisions*, 46 ESTATE PLANNING 23 (January 2019).

III. Income tax treatment of installment sales: General Principles.

The Installment Method of Accounting

When property is sold at a gain, and on terms that provide for deferred payments, there is a perception that immediate taxation of the entire gain may be inappropriate. For more than eighty years,[3] the Internal Revenue Code has allowed the seller to defer the reporting of the gain under the *installment method* if there is an *installment sale*—one in which one or more payments of the selling prince are to be made in tax years after the year of sale.

The income tax treatment of installment sales is found in § 453, the accounting subpart of the Internal Revenue Code. The installment method is a method of accounting used to determine *when* a gain that has been *realized* and *recognized* on a sale is reported.[4] It is not limited to cash method taxpayers. The installment method of accounting must be used by all taxpayers, regardless of their general methods of accounting, even taxpayers who use the accrual method. The installment method of accounting permits a taxpayer to defer the reporting of a gain arising from the tax year the property was sold to the tax years in which payments of the selling price are received by the taxpayer/seller.

Section 453 provides for use of the installment method for qualifying sales without regard to the taxpayers' general method of accounting—cash, accrual, or something else—when there are payments of the selling price to be received after the year of sale. The deferred gain is reported in income in the year of payment, taxed as part of the gross income realized in that year, generally under the rates in effect in that year, not the year of sale, unless Congress provides otherwise, as it has sometimes done. Because the installment method of accounting only determines the tax year in which the gain is reported, the annual accounting principle requires that the gain be taxed at whatever rates are in effect for the year reported.

A. Eligible Sales

The statutory language first states the general rule that the installment method applies to *all* installment sales of property (unless the seller elects out). The statute then goes on to list exceptions to this general rule. There are two categories of ineligible sales. The first disqualified category covers certain kinds of assets that are never eligible for the installment method. The second disqualified category covers certain assets that would otherwise be eligible, but cannot qualify for the installment method because the deferred payment sale is between related parties.

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[3] The installment method was first adopted by the Revenue Act of 1926, Public Law 20-69th, 44 Stat. 9 (1926).

[4] All *realized* gains are *recognized* unless a non-recognition provision applies. § 1001(c) and Reg. § 1.1002-1. Only after the *realized* gain is *recognized* is it necessary to determine *when* that gain is reported. If the realized gain is not recognized, there is no gain to be reported. Thus, there is no need to go on to determine *when* the gain is reported.

As revised in 1980, the installment method was conceived as the basic method for taxing deferred payment sales, with the only significant exceptions being for inventory and dealers in personal property, the related party rules and depreciation recapture gain. In the intervening years, other exceptions have been added, such as the exception for marketable securities in 1984, so that, as a practical matter, the installment method primarily applies to sales of capital assets and section 1231 property to the extent not subject to recapture. However, the installment sale of certain assets that are not capital assets (see § 1221(a)(3) for intellectual property in the hands of the creator) is eligible for the installment method even though the gain would be an ordinary gain. This result follows because the definition of a qualifying installment sale is a negative definition; all assets qualify unless a statutory exception exists. Thus, it is possible to use the installment method to postpone the reporting of an ordinary gain realized from the sale of an asset that is not a capital asset.

Sales of inventory have long been disqualified. There is also an exception for marketable securities and for depreciation recapture gain (in addition to the provision for related party sales of depreciable property). Although the exclusion refers to § 1250 depreciation recapture relating to the real estate, most real estate placed in service after 1986 is not subject to depreciation recapture (even though unrecaptured § 1250 gain is subjected to a higher capital gain rate under § 1(h)(6)) because it is depreciated using the straight-line method. The inability of a depreciation recapture gain to qualify for the installment method is based on depreciation deductions that created a deduction that offset ordinary income.

B. Ineligible gains: Depreciation recapture income

That portion of the gain realized upon the sale of an asset that would be characterized as ordinary income under the depreciation recapture rules is not eligible for deferral under the installment method.[5] Instead, the recapture portion of the gain must be reported at the time of the sale. However, the remaining portion of the gain (the § 1231 portion of the gain) can be deferred under the installment method. Reporting the recapture income has the effect of increasing the seller's basis for purposes of determining the gross profit ratio applied to all payments received.

> **Example** S's adjusted basis in a depreciable asset is $20. The machine is sold for $100, with a $20 down payment and four annual installments of $20 each, plus interest. The asset is eligible for the installment method. But, the $80 gain includes $10 of recapture income under § 1245. For purposes of calculating the gross profit ratio, S has a basis of $30 (S's original $20 adjusted basis plus the $10 recapture income reported at the time of sale) so that the gross profit is $70 and the gross profit ratio is 70%. For the year of sale S reports $10 of ordinary income under the depreciation recapture rules and $14 of § 1231 gain with respect to the $20 received as a down payment.

[5] § 453(i).

C. Payment of Interest on the Deferred Income Taxes: The Interest Charge Rules under Section 453A

Although the gains from most deferred payment sales of assets such as real estate held for rental purposes or held as property used in a trade or business (§ 1231 assets) can be reported under the installment method, under certain circumstances the seller may have to pay interest to the Government because of the ability to postpone the payment of taxes on the gain from the sale.[6] In addition, where a dealer can use installment sale reporting for the sale of timeshares or residential lots, the payment of interest is also required.[7]

This special interest charge only applies to an installment sale if the sales price is more than $150,000.[8] Furthermore, the special interest charge is imposed only if the aggregate of all of the deferred payments sales using the installment method for the tax year exceed $5 million.[9] The amount of the special interest charge is computed on the deferred tax liability with respect to the gain that is postponed.[10] However, the seller need only pay the special interest charge on a portion of the deferred tax liability.[11] If a taxpayer does not engage in more than $5 million in deferred payment sales for a year, reported under the installment method, then none of the deferral advantages arising from use of the installment method result in an interest charge.[12] If a taxpayer's aggregate installment sales are $15 million for the year, then the special interest charge is computed on the income taxes deferred from two-thirds of the gains.

When the seller is a pass-through entity, such as a partnership or S corporation, Notice 88-11, 1988-2 C.B. 397 provides that the $5,000,000 threshold is applied, and interest calculations are made, at the owner level. For example, if there are two S corporation shareholders, owing 40% and 60% respectively, and if the S corporation sells an eligible asset for a $10,000,000 installment note, then the installment sales are $6,000,000 and $4,000,000 for the shareholders. Thus, the 40% shareholder is not exposed to the special interest charge, and the 60% shareholder has to pay the special interest charge on the postponed gain inherent in only $1,000,000 of the installment note.

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6 § 453A(a)(1).

7 § 453(l)(3).

8 § 453A(b)(1).

9 § 453A(b)(2)(B).

10 § 453A(c). Section 453A(c)(2)(B) provides that the interest rate used to determine the charge for the deferred tax liability is determined under § 6621(a)(2), the deficiency rate for under payments of taxes. The underpayment rate is the short-term AFR for the month the sale takes plus 3 percentage points.

11 § 453A(c)(2).

12 § 453A(c)(4).

There are two remaining questions. First, can spouses be treated as separate taxpayers even though they file a joint income tax return? Second, does the $5,000,000 per person limitation under Section 453A apply each year to sales occurring only within that year or is it is cumulative, applying to all installment sales occurring over all tax years? We conclude that spouses are separate taxpayers and that the $5,000,000 is an annual threshold applied separately each year.

A careful reading of § 453A will indicate that the $5,000,000 threshold is an annual one, imposed on each taxpayer. Thus, a taxpayer can engage in a $5,000,000 installment sale on December 31 of year 1 and another $5,000,000 installment sale on January 1 of year 2, and § 453A will not apply. The statute itself is clear on its face. Section 453A(b)(2)(B) provides:

> The face amount of all such obligations held by the taxpayer which arose during, **and** are outstanding as of the close of, such taxable year exceeds $5,000,000.

The use of the word "**and**", a conjunctive, means that both conditions must be satisfied. The obligations must have arisen during that year **and** must be outstanding as of the close of that year. The language "are outstanding as of the close of" was intended to exclude an installment obligation which arose during the year but which was satisfied before the end of the year in which it arose.[13] If Congress intended that the threshold be cumulative, it would have used the word "**or**" instead of "**and**" in the statute.

The deferred interest charge applies to an installment sale in excess of $5,000,000, even though in subsequent taxable years the principal on the installment obligation is reduced below the $5,000,000 threshold. For example, assume there is a sale in Year 1 for a $7,000,000 installment note. The gain would be with respect to the amount in excess of the $5,000,000 threshold, would be subject to the interest rule under Section 453A. If there are subsequent principal payments on the $7,000,000 installment note which reduces the outstanding principal balance below $5,000,000, the interest charge continues to be assessed. If the cumulative approach was used, there would be no need to have this continuation of the interest charge rule even if the note is paid down below $5,000,000 of principal, since all subsequent installment sales in subsequent years (even below $5,000,000 in any one year) would be subject to an interest charge. The Senate Finance Committee Report to the 1987 Act [14]provides:

> If the interest charge is applicable for any taxable year, it continues to apply until all payments under the installment obligations arising during the year are received, even though the aggregate face amount of the obligations may later be reduced below $5,000,000.

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13 An examination of the 1987 legislative history (the Senate Finance Committee Report and the Conference Committee Report) shows that Congress did not address this question. Therefore, the legislative history is not determinative on this issue.

14 Page 163 (October 16, 1987).

IRS Form 6252, which provides for reporting of interest payments, does not address this issue.[15] Given the plain meaning of the language in Section 453A(v)(2)(B), and the fact that there are no administrative pronouncements issued by the IRS to indicate otherwise, the $5,000,000 threshold should be applied separately to each taxable year.[16]

Section 453A(b)(2) provides that the interest charge applies to an obligation arising during the taxable year only if "the face amount of all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000." A question arises as to whether this language refers to (a) two categories of obligations— those that arose during the year and those that are outstanding as of the close of the year (regardless of when they arose), or (b) only one category of obligations--those that arose during the year and remain outstanding as of the close of the year. Based on the statutory language of Section 453A(b)(2), we believe the latter definition (b) is correct – i.e., each obligation must both arise during the taxable year and be outstanding at the close of the taxable year to be counted against the $5 million ceiling."[17] Therefore, the $5 million limitation in Section 453A applies on an annual basis. In other words, a taxpayer may exclude from the Section 453A(b)(3) limitation up to $5 million of installment new obligations each year.

When the Internal Revenue treats a husband and wife as one taxpayer with respect to certain situations, there is always a specific statutory provision which mandates such treatment. Without such a specific statutory mandate, the general rule is that a husband and wife are separate taxpayers. Prior to the enactment of legislation treating a husband and wife as a single shareholder for S corporation eligibility purposes, they were treated as separate tax persons.[18] In addition, Section 163(h) provides a limitation on the amount of indebtedness that can be treated as eligible for home mortgage interest deductions, *i.e.*, $1,000,000, except that it is $500,000 in the case of a married person filing separately. This indicates that for purposes of Section 163(h), married persons are treated as one taxpayer. Similarly, Section 68, limiting itemized deductions for persons with incomes in excess of $100,000, provides for a threshold of $50,000 in the case of a married individual filing separately.

Section 453A does not provide a different threshold for a married individual filing separately. A married person filing separately may apply a threshold of $5,000,000, even if his or her spouse is using the same threshold for obligations he or she owns.

Neither the Code nor the Regulations indicate whether the $5 million limitation applies to a husband and wife as a single taxpayer, or it applies separately to each (so the collective limitation amount would be $10 million). However, TAM 98-53-002 (Sept. 11, 1998) concludes that a husband and wife "are not a single taxpayer for the purpose of applying the $ 5,000,000

[15] Publication 537 Installment Sales, which contains the IRS's instructions on how to report installment sales, does not address this issue.

[16] See Bittker & McMahon, Federal Taxation of Individuals, ¶ 41.03[3], stating that the limitation applies on an annual basis.

[17] H.R. REP. NO. 495, 100th Cong., 1st Sess. 929, 930 (1988).

[18] § 1361(c)(1)(A)(ii).

limitation of section 453A." The TAM indicates that its conclusion that a husband and wife are subject to a separate $5 million limitation applies even if the they file a joint return.[19]

It is important to remember that a husband and wife who file a joint income tax return for the year are separate taxpayers, even though they have joint and several liability for the income taxes due for that year. Since the $5,000,000 threshold is a per person threshold, a husband and a wife can each engage in separate $5,000,000 installment sales for the year,[20] effectively increasing the threshold for the special interest charge under § 453A to $10,000,000 for the year.

D. RELATED PARTIES: INTRA-FAMILY INSTALLMENT SALES

As with many other situations, installment sales between related parties provide potential for abuse, particularly when the purchaser obtains the immediate benefit of the purchase price basis for deprecation or other purposes, while the related seller defers the gain, often for a very long time if the sale is for a balloon payment, twenty or more years in the future. Although the same lack of symmetry exists for installment sales among unrelated parties, the potential for planning and abuse is obviously greater within a family or other group with common economic interests. One of the political factors that made simplification and reform of the treatment of deferred payment sales by the Installment Sales Revision Act of 1980 feasible was that the Service became anxious to attack such tax planning. See *Rushing v. Commissioner*, 441 F.2d 593 (5th Cir. 1971).

Section 453(e) was enacted to eliminate the planning technique used in *Rushing*, which is characterized as the family having the cash proceeds of the sale but deferring the tax. Section 453(e) accelerates gain only when the purchaser makes a second disposition within two years of the initial installment sale. There are also several exceptions to this 2-year resale rule, including dispositions caused by the death of the seller or the related party purchaser, and where tax avoidance was not a principal purpose of the transaction.

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[19] See Kaden and LaFrance, *Installment Method Asset Sales by S corporations*, 39 American University Law Review 930, 932 (year), concluding that the limitation is applied on an annual basis.

[20] Under § 1041 and the unlimited gift tax marital deduction, spouses can rearrange their ownership of property without any income tax or gift tax exposure. Thus, a spouse owning an asset valued at $10,000,000 can gift half of that asset to the other spouse so that both spouses can take advantage of the $5,000,000 threshold.

E. Installment Sales of Encumbered Assets

> **Example** S owns a vacant parcel of land held as an investment. S's basis in the land is $60,000, and its market value is $100,000. The land is subject to a $35,000 mortgage. Under a contract of sale, B purchases the land and agrees to pay S only $65,000 in cash as B will take title to the land subject to the $35,000 existing mortgage. S's amount realized on the sale is $100,000, consisting of the cash received and the mortgage shifted to B. Since S's basis is $60,000, the realized gain is $40,000.

The general tax principle that a transfer of a liability is a payment applies to an installment sale, but with a twist. Under the installment method, the gain is prorated, not by allocating payments as a percentage of the selling price, but as a fraction of the "contract price." The contract price is the selling price, reduced by liabilities transferred, at least to the extent that they do not exceed the basis of the property sold. Thus, the transfer of the liability is not a payment that results in immediate recognized gain (at least when the liabilities do not exceed basis), and the liabilities are, in effect, applied first against the basis of the property sold. This means that the entire gain can be allocated to the cash payments of principal to be made with respect to the installment note.

Special rules apply to the determination of the contract price[21] and gross profit ratio[22] when the property sold is subject to liabilities. In addition, a liability can sometimes result in a portion of the liability taken over by the buyer being treated as a fictional payment of cash received at the time of the sale.

Pursuant to the installment method, the seller reports as gain from the sale a portion of each payment received. And, that portion is reported in the year the payment is received.[23] The portion of each payment treated as gain is commonly referred to as the gross profit ratio. The following formula is used to make the computation:

$$\text{Gain Reported} = \text{Payments received} \times \frac{\text{Gross Profit}}{\text{Contract Price}}$$

Gross Profit A Seller's gross profit is the excess of the amount realized on the sale over the seller's adjusted basis in the property.[24] Remember that the amount realized includes

21 Temp. Reg. § 15A. 453-1(b)(2)(iii).

22 Temp. Reg. § 15A. 453-1(b)(2)(i).

23 § 453(c). Gross profit ratio = 100%

24 Temp. Reg. § 15A. 453-1(b)(1) and (2)(v).

cash, the value of other property received and any liabilities of the seller transferred to the buyer.

Contract Price The contract price when liabilities are involved is generally the selling price[25] reduced by any outstanding mortgages on the property assumed or taken subject to by the buyer. However, this reduction in the selling price for liabilities cannot exceed the seller's basis in the property sold.

Payments Received A payment includes not only cash and the value of other property received, other than the buyer's installment note. A payment also covers the amount by which the mortgage on the property sold exceeds the seller's basis in the property.

> **Example 1** S, a cash method taxpayer, owns an unimproved parcel of land held as an investment, with a basis of $30,000 and a value of $100,000. The land is subject to a $30,000 mortgage. S sells the land to B for $100,000, receiving $20,000 in cash and B's promissory note for $50,000, payable $10,000 a year, plus 10% annual interest on the unpaid balance. B agrees to take the land subject to the existing mortgage. The first annual payment on the note is due one year from the date of sale. The sale takes place on January 1, 1988. The selling price, *i.e* amount realized, is $100,000, consisting of $20,000 in cash, a note valued at $50,000 and the $30,000. Accordingly, the realized gain is $70,000.
>
> The gross profit ratio is 100%, computed as follows:

Gross Profit	=	$70,000
Contract Price		$70,000

The gross profit is also the gain realized. The contract price is the selling price reduced by the full amount of the mortgage. Therefore, 100% of each payment is treated as gain on the sale, and is reported as follows:

Year	Gain on Sale
1988	20,000
1989	10,000
1990	10,000
1991	10,000
1992	10,000

25 Temp. Reg. § 15A. 453-1(b)(2)(ii).

Year	Gain on Sale
1993	10,000
Total gain reported	*$70,000*

Example (2) S owns property with an adjusted basis of $30,000 and a value of $100,000. The property is subject to an outstanding mortgage of $40,000. At the time of the sale S receives $10,000 in cash and a $50,000 installment note, 10% annual on the outstanding principal and annual principal of $10,000 with the first Principal and interest payment due 12 months after the sale.

The selling price is $100,000, consisting of the cash received, the $10,000, the value of the note, $50,000, and the $40,000 mortgage taken over by the buyer. The realized gain and the gross profit are $70,000. In arriving at the contract price, the selling price is reduced by the amount of the mortgage, but only up to the seller's $30,000 basis in the property. Therefore, the gross profit ratio is 100%. The $10,000 amount by which the mortgage exceeds the basis is treated as a cash payment at the time of the sale. Accordingly, S is treated as having received $20,000 in the year of sale. The $70,000 of gain realized from the sale is reported the same as in Example (1) above.

IV. How to shift the immediate reporting of phantom gain (mortgage liabilities in excess of basis) to the later payment of the principal on the installment note received upon an installment sale of the appreciated partnership interest to a non-grantor trust for the benefit of one's descendants.

With encumbered real estate, especially real estate where the mortgage liabilities exceed the adjusted income tax basis, there has been a tendency for the real estate owner to retain ownership until death to obtain an income tax-free step-up in basis at death. This has created a lock-in effect as owners who may otherwise have sold the real estate while living, decline to do so because they do not want to report and pay income taxes on a large taxable gain. Frequently, the real estate owner no longer can obtain the step-up in basis at death because the real estate has been transferred to an irrevocable trust whose assets are not exposed to the estate tax.

Today's presentation will address how to deal with encumbered real estate the owner intends to continue to own and pass at death. The third part will demonstrate how one can defer the reporting of the gain one realizes when the encumbered real estate with liabilities in excess of income tax basis is sold by the owner (the owner can be an individual or an irrevocable trust who are a partner in the partnership that owns the encumbered real estate).

Where the asset is encumbered by liabilities, the old paradigm may still be appropriate because the estate tax is imposed only upon the equity in the property (gross value less liabilities).

> **Example:** D owns fully depreciated residential real estate that was placed in service in 1983. Its current value is $54,000,000, and its adjusted income tax basis is $4,000,000. The real estate is encumbered by a $44,000,000 mortgage liability. If the real estate is held by D at death, the 40% estate tax applies to the $10,000,000 equity, an estate tax cost of only $4,000,000. Since the estate's income tax basis becomes $54,000,000, a portion of that tax basis can be allocated to the building and be depreciated.

Had this real estate been sheltered from the estate tax, there would have been a $50,000,000 gain if the real estate was sold. Financially the sale would have created a burden as the income taxes on this gain would have been in the $16,000,000 range, an amount exceeding the $10,000,000 of cash netted from the sale.

Evaluating whether to shift an asset out of the estate.

As the above example illustrates, all the income tax factors need to be evaluated before deciding to transfer an asset out of the decedent's estate. The first step is to determine the estate tax cost for exposing an appreciated asset to the estate tax and compare that estate tax cost to the income tax savings if there is an expectation that the asset will be sold after the decedent dies. Even if there is an expectation that the encumbered real estate will not be sold, one must evaluate the potential income tax savings for the increase in depreciation deductions that can be obtained from the tax-free set up in basis at death. Remember depreciation creates ordinary deductions that can offset ordinary income.

With this treatment of negative basis real estate in mind, it is possible to postpone the reporting of all the gain, including the phantom gain, using a partnership. Given that a partner's partnership interest is treated as a single unitary asset, using the following example, there is $5,000,000 of phantom gain that would be immediately reported if the partnership sold its negative basis real estate, even though the installment method would apply to the remainder of the gain.

PARTNERSHIP BALANCE SHEET

Asset	*Basis*	*Value*	*Liabilities*	*Value*
Real Estate	$4,000,000	$15,000,000	Mortgage	$9,000,000
			Capital Accounts	
			General Partner	$0[26]
			Senior	$6,000,000
Totals		**$15,000,000**		**$15,000,000**

The mortgage in excess of basis is frequently referred to as "phantom gain." It is sometimes referred to as a negative basis. Actually, it is a $5,000,000 negative capital account.

If Senior sold her partnership interest for a $6,000,000 installment note, Senior would realize an $11,000,000 gain but would be able to use the installment method to defer only $6,000,000 of the gain because the $5,000,000 excess of liabilities over basis is treated as a fictional payment of cash at the time of the sale.

The planning calls for Senior to contribute an unencumbered asset with a basis of $5,000,000 to the partnership, increasing Senior's basis in her partnership interest to $9,000,000. After this additional capital contribution, Senior's $9,000,000 share of partnership liabilities no longer exceeds the $9,000,000 basis in her partnership interest.

> **Step 1:** Senior's basis for her partnership interest is equal to the partnership $4,000,000 inside basis.
>
> Senior has a separate capital asset with a value and a basis of $5,000,000. Senior contributes this capital asset to the partnership, increasing Senior's basis in her partnership interest and her capital account by $5,000,000. Senior's basis in her partnership interest is now $9,000,000. Because all we

[26] The General Partner has a profit only interest as it is a service provider who receives a share of profits in return for providing services. Thus, the GP need not make a capital contribution.

need is basis, the value of the contributed asset is not relevant and can even be an asset with a built-in loss.

PARTNERSHIP BALANCE SHEET

Asset	*Basis*	*Value*	*Liabilities*	*Value*
Real Estate	$4,000,000	$15,000,000	Mortgage	$9,000,000
Capital Asset	$5,000,000	$5,000,000	*Capital Accounts*	
			General Partner	$0[27]
			Senior	$11,000,000
Totals		**$20,000,000**		**$20,000,000**

Step 2: Senior creates and funds an irrevocable, non-grantor trust for the benefit of Senior's descendants. As a complex trust, it is a separate taxpayer for Federal income tax purposes, and any sales by Senior to the trust will be an income tax realization event.

Step 3: Senior proceeds to sell her entire partnership interest to the complex trust for an interest-only $11,000,000 promissory note,[28] with all principal due in 22 years. The trust's cost basis in the partnership interest is now $20,000,000 as the trust includes in its cost basis for the partnership interest its share of partnership liabilities.[29] The partnership should not make a Section 754 election to increase its basis in the depreciable real estate by the $5,000,000 special basis adjustment under Section 743(b) because § 1239 will characterize the entire $11,000,000 gain as ordinary income when there is a sale of depreciable property to a related party and because § 453(g) prohibits using the installment method to defer gain realized upon the sale of depreciable property to a related party .

Since the selling partner's basis in her partnership interest is now $9,000,000, and since Senior's share of partnership liabilities is only $9,000,000,[30] upon the sale of the partnership interest there are no liabilities in excess of basis. Instead, the gross profit ratio is 100%. Therefore, the reporting for the entire $11,000,000 gain is deferred until the note principal is paid at maturity of

27 The General Partner has a profits only interest as it is a service provider who receives a share of profits in return for providing services. Thus, the GP need not make a capital contribution.

28 Because of the § 453A interest charge, if Senior is not married, there needs to be three separate sales for $5,000,000, $5,000,000 gain and finally $1,000,000. If Senior is married, Senior and Senior's spouse can do two $5,000,000 sales in the current year and a $1,000,000 sale the following tax year.

29 § 752(c).

30 § 752(d).

the note. Under the installment sale regulations, the $9,000,000 liability is treated as a return of Senior's basis in the partnership interest it sold, leaving no basis to be allocated to the $11,000,000 installment note. Because Senior now has a zero basis in the $11,000,000 installment note, the entire $11,000,000 of gain will be reported in 20 years upon the maturity of the interest only promissory note.

> **Step 4**: After waiting for two years (24 months),[31] the partnership sells the real estate for $15,000,000, receiving only $6,000,000 in cash as the buyer took the real estate subject to the existing mortgage liability. The partnership reports an 11,000,000 gain. Since the trust's share of partnership liabilities has declined by $9,000,000, the trust reduces its basis for its partnership interest to $11,000,000.[32] The trust increases its basis for its partnership interest by its share of the $11,000,000 gain, to $22,000,000.
>
> **Step 5**: The partnership then terminates[33] *in the same year the sale of the real estate occurre*d, distributing the $6,000,000 cash and the $5,000,000 capital asset to the trust. The trust first reduces the basis in its partnership interest by $6,000,000 of cash received, leaving the trust with $16,000,000 basis to be substituted as the basis in the capital asset received in a liquidating distribution. The trust then sells the capital asset for its $5,000,000 value, reporting an $11,000,000 capital loss that can offset its $11,000,000 capital gain.

By not violating the two-year resale rule (a liquidation of a partnership is treated as a sale of the partnership interest), the $11,000,000 of gain can continue to be deferred by Senior under the installment method.

Alternative: If, before the two-year waiting period expires, the partnership distributes the capital asset with a basis and value of $5,000,000 to the trust, the trust's $20,000,000 basis in its partnership interest is reduced by the $5,000,000 basis the trust takes in the distributed asset, reducing its basis in its partnership interest from $20,000,000 to $15,000,000. The partnership's only asset will now be the encumbered real estate with a basis of $4,000,000, a value of $15,000,000 and a liability of $9,000,000. After the two-year waiting period expires the partnership sells the encumbered real estate subject to the mortgage, realizing the $11,000,000 gain, but only $6,000,000 of cash. The trust first increases its basis in its partnership interest by the $11,000,000 gain and then reduces its basis in its partnership interest by the $9,000,000 reduction of partnership liabilities. Now the trust's basis in its partnership interest is $17,000,000. The partnership then terminates by distributing it $6,000,000 of cash, which reduces its outside basis by the $6,000,000 to $11,000,000. As a liquidating distribution, the

[31] As an installment sale to a related party, § 453(e) imposes a two-year waiting period before the related party purchaser can resell the asset purchased. A liquidating distribution of a partnership interest is treated as a disposition of a partnership interest and will then be treated as a second disposition under § 453(e)

[32] § 752(b).

[33] A redemption of a partnership interest is a sale (i.e. a second disposition) that needs to satisfy the two-year safe harbor under § 453(e).

trust can report its $11,000,000 of unrecovered basis as a capital loss that can be used to offset the $11,000,000 of capital gain if both the capital loss is reported in the same year the capital gain was reported.

V. The preferred partnership freeze for mortgaged real estate.

Where an appreciated asset is subject to a liability, one should use a technique that retains that portion of the asset subject to the liability in the individual's gross estate as the amount exposed to the estate tax is the gross value of the asset less the liability encumbering the asset (*i.e*. the equity in the asset). The often-overlooked preferred partnership freeze is designed to accomplish this objective. Under § 2701 Congress provided a safe-harbor roadmap for structuring the preferred partnership freeze. In effect, the § 2701 freeze can shift future appreciation without the income tax cost that comes with carryover basis. Perhaps the most compelling fact pattern where the § 2701 freeze is advantageous is a highly leveraged asset with a low adjusted income tax basis, typically existing in real estate held in a partnership or in a limited liability company which is characterized as a partnership for Federal income tax purposes. For leveraged real estate, the § 2701 freeze is typically the only method that can eliminate the negative capital account or phantom gain upon the death of the holder with little or no estate tax exposure.

Where the liabilities encumbering real estate exceed the income tax basis for the assets, the real estate is commonly referred to as *negative basis property*.[34] If the real estate with liabilities that exceed basis is sold, the amount of the gain on the sale is determined by treating both the cash proceeds and all of the liabilities as part of the sale price, thus giving rise to what is commonly referred to as *phantom gain*.[35] Since the phantom gain can be eliminated if the negative basis asset is included in the gross estate upon the death of the owner,[36] the estate planner needs to take this into account when considering an estate planning technique designed to shift this asset out of the individual's gross estate.

A. History of the § 2701 Freeze

Prior to the enactment of § 2701 in 1990 as part of the Chapter 14 regime, preferred partnership freeze techniques were referred to as "capital freezes."[37] This term was a reflection of the fact that under the state of the art planning at that time, no capital needed to

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[34] Liabilities in excess of adjusted tax basis can occur where the property is fully depreciated, especially when a cost segregation study has been implemented, the present property is the successor in a line of like-kind exchanges under § 1031 or the owner has financially realized upon the appreciation in value by a series of income tax-free refinancing as loan proceeds are not taxable gain. *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2nd Cir. 1952).

[35] *See Commissioner v. Tufts*, 461 U.S. 300 (1983).

[36] *Crane v. Commissioner*, 331 U.S. 1 (1947).

[37] Revenue Reconciliation Act of 1990, (October 27, 1990).

be transferred for the preferred partnership freeze to accomplish the intended objectives. In effect, one could retain the principal and shift the appreciation in the principal without transferring any value under the gift tax. Prior to the enactment of § 2701 it was much easier than it is today to simply "shift" value to the next generation.

The pre-1990 capital freeze first involved the recapitalization of a business entity (whether a partnership or a corporation) into separate classes of ownership interests. After the recapitalization, there would be a preferred interest and a common interest. The preferred interest would be entitled to a priority return on its capital and a liquidation preference upon the occurrence of a liquidity event. However, unlike under current law, there was no need to provide for preferred dividends or preferred distributions that would actually be paid. The preferred dividends or the priority return could be non-cumulative so that if not paid in one year (or for several years) the holder of the preferred interest would not be entitled to a makeup distribution in future years. The non-paid preferred dividend or priority return would be lost – or perhaps more aptly put – shifted to the holders of the junior equity. Moreover, the rights to a liquidation preference could be illusory. Under the entity's organizational documents, the right to the liquidation preference could lapse under certain circumstances, such as upon the death of the holder of the preferred interest. Likewise, the holder of the preferred interest could have a lapsing right to "put" its interest to the entity for a fixed price or to a "call" its capital from the entity in a redemption. However, these rights would seldom be exercised in the family context. They were mainly inserted into the transaction as window dressing so appraisers would attribute all or almost all of the value to the preferred interest which would reduce or, more likely, negate a gift upon the gift of the common interest to a trust for the younger generations.

Within the family context, there thus existed the opportunity to shift all appreciation in value to the holders of the junior equity interests since they would benefit from the nonpayment of dividends on the senior preferred, the lapsing liquidation rights, etc. While an appraisal of the preferred interest would recognize these rights as enhancing the value of the preferred interest, that value would be illusory. It was typically the case that an appraisal could value the preferred interest at 100% of the value of the entity leaving no value to be allocated to the junior interest. Any option value to the junior interest would typically be ignored even though it constituted real economic value. Outside of the family context the option value was meaningful since it represents the rights of the holders of the junior equity to participate in the growth in value or upside of a business enterprise. As a result of the manner in which the junior interest would have been valued under pre-chapter 14 authorities, the transfer of the common interest would have little to no gift tax value – even though in reality, its represented a significant shifting of wealth to the holders of the junior equity.

Today, there are a number of provisions set forth in Chapter 14, mostly in Section 2701, specifically designed to preclude this type of planning. Section 2701 was enacted to preclude these perceived abuses involving entity freezes that were condoned by case law.[38] These cases involved, inter alia, rights belonging to the senior preferred interest holders that lapsed upon death, but which were taken into account in determining the value of the preferred interest.[39] Section 2701 has reigned in many of these types of abuses. The Section 2701 rules which eliminated these abuses are in the form of what rights the preferred interest must have so that the gift of the common interest will have a statutorily minimum value for gift tax purposes. By setting for the requirements for the preferred equity interest, Section 2701 now provides a safe harbor set of rules that, if followed, eliminate all of the uncertainty surrounding the preferred partnership freeze.

Another development that indirectly impacted the use of the entity freeze is Section 1274 which requires the use of the Applicable Federal Rate (the "AFR") for all deferred payment sales. Section 1274 was enacted in 1984 to combat abuses involving low interest purchase money indebtedness used on property acquisitions (*i.e*. seller-provided financing) to either (i) inflate depreciation deductions and thus increase the tax shelter resulting from the purchase of income producing properties or (ii) convert interest income taxable at ordinary income tax rates into capital gains Prior to the enactment of Section 1274, artificially low interest rates could be charged so that the same level payment would support a higher nominal purchase price for such property. The higher nominal purchase price resulted in disguising interest as principal, thus converting ordinary income into capital gains and inflated depreciation deductions which could be made available to offset unrelated income – thus a tax shelter.

Although Section 1274 was intended to govern income tax deferred payment sales, it had a positive impact on freeze techniques used for estate planning that was likely unintended. This impact has been amplified in the current exceptionally low interest rate environment. Since the AFR is determined by reference to the one-year Treasury bill rate, it is always a below market interest rate, even in high interest rate environments. For example, a father could sell a $1,000,000 corporate bond paying 3.0% interest to a son, and take back the son's 9-year, interest only, promissory note paying only 1.0% in satisfaction of the entire selling price, thus allowing the son to keep the excess each year without any gift tax.

Since Section 1274 only applies to deferred payment sales, the AFR is not used to determine the priority return that must be paid on a preferred equity interest. Instead, the preferred return that must be paid in the § 2701 freeze is determined by market forces. Other

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[38] *See Estate of Harrison v. Comm'r*, 42 T.C.M. 1307 (CCH) (1987); *Estate of Watts v. Comm'r*, 51 T.C.M. 60 (CCH) (1985), *aff'd*, 823 F.2d 483 (11th Cir. 1987); *Estate of John G. Boykin*, 53 T.C.M. 345 (CCH) (1987).

[39] *See* Tech. Adv. Mem. 85-10-002 (Nov. 26, 1984) and Tech. Adv. Mem. 84-01-006 (Sept. 28, 1983) (holding that decedent taxpayer's voting control should be considered in valuing stock for estate tax purposes where the taxpayer owned voting shares in a family-owned corporation that became nonvoting at his death).

freeze techniques may rely on the AFR which is typically a far lower rate. The AFR will almost always be lower than the market rate of return payable on a preferred interest.[40]

B. Exposing encumbered real estate to the estate tax or to the income tax.

The following example is designed to illustrate that in situations where the amount of liabilities in excess of adjusted income basis is significant, that the income tax savings can far exceed the estate tax cost of including the asset in the individual's gross estate and having to pay the estate tax.

> **Example** Senior owns a commercial office building held for rental. Senior purchased this property in 1984 for $20,000,000 and allocated $16,000,000 of the purchase price to the building. Senior was able to depreciate the entire amount allocated to the building over 18 years using an accelerated method of depreciation. Moreover, over the years Senior was able to take substantial funds out of the building tax-free by means of periodic mortgage refinancing. At present, the gross value, mortgage liability and adjusted tax basis for the building are:

Gross Value	$ 54,000,000
Adjusted basis	4,000,000
Mortgage	44,000,000
Equity	10,000,000[41]

Since an accelerated method of depreciation was used, all 16,000,000 of depreciation on the building is recaptured as Section 1245 ordinary income.[42] as in effect before the Tax Reform Act of 1986 which treated all buildings using an accelerated method and an 18-year recovery period as Section 1245 recovery property.[43]

If Senior died when the maximum estate tax rate is 40%, and assuming Senior's domicile at death was a state with no estate tax (and assuming no available credit against the estate tax

40 Rev. Rul. 83-120, 1983-2 C.B. 170, provides guidance by providing that a market based approach must be used to determine the priority return for a preferred entity interest.

41 The $10,000,000 equity is determined by offsetting the $54,000,000 gross value by the $44,000,000 mortgage liability.

42 Section 1245(a)(5)

43 Public Law 97-34, § 204(c). Code § 1245(a)(5) is still applicable for property placed in service between 1981 and 1986 but is no longer in the Code; Public Law 99-514, § 201(d)(11)(D).

under § 2010), the estate taxes (40% x $10,000,000 equity) would be $4,000,000. And, the estate's income tax basis in the commercial office building would be stepped up, income tax-free, to $54,000,000. If the value of the land is $14,000,000, then the estate, or other successor-in-interest, can depreciate the $40,000,000 allocated to the depreciable building over 27½ (for residential rental buildings) or 39 years (for commercial buildings) (and quicker if a cost segregation study were used).[44]

Instead, Senior is alive and decides to sell the property. Since the property is located in New York City, the combined state and city income tax rate is 10%. If Senior sells the real estate, netting $54,000,000 (after selling expenses), the $50,000,000 gain realized on the sale will be taxed as follows:

Gain	*Combined income tax rate*	*Federal and state income taxes*
$16,000,000 ordinary income	50%	$ 8,000,000
$34,000,000 capital gain	30%	<u>$10,200,000</u>
Total income taxes		**$18,200,000**

The advantage of being subject to the Federal estate tax is the complete elimination of the $50,000,000 of gain, including the $40,000,000 of phantom gain (excess of liabilities over adjusted tax basis) without exposing any of the phantom gain to the estate tax. So, at an estate tax cost of only $4,000,000, applying the Federal estate tax eliminates $18,200,000 of income taxes if the property is to be sold and no like-kind exchange is used.

As is readily apparent, selling the building is not financially advisable. The $10,000,000 of net sale proceeds after the payment of the mortgage would be far less than the income taxes on the gain. Thus, there are many properties where the owners are reluctant to sell because the income taxes on the phantom gain can result in a negative cash position. The owners of negative basis real estate are inclined to hold the property until they die to eliminate not only the phantom gain, but all of the built-in gain and are willing to pay the estate tax on the real estate in order to obtain the income tax-free basis step-up at death.

Even if the property is not sold by Senior's estate, and continues to be operated as a rental property, the step-up in basis at Senior's death creates an additional $50,000,000 of basis that can be taken as depreciation deductions over 39 years (and over 27½ years if the depreciable building is a residential rental property and more rapidly for a portion if a cost segregation study is used). Since the depreciation deductions are ordinary deductions, those deductions will save an additional amount in taxes over the depreciable recovery period. If

44 § 168(c).

$40,000,000 is allocated to the depreciable building, and the combined effective income tax rate is 45%, the income tax saved by $40,000,000 of depreciation deductions is $18,000,000.

Even for buildings placed in service after 1986, the gain attributable to the straight line depreciation on the building is taxable at a Federal rate of 25% as "unrecaptured Section 1250 gain."[45]

The estate tax disadvantage of holding the real estate until death is that all future appreciation in value is also exposed to the estate tax. And, given that real estate values today are generally depressed, many building owners feel that their real estate holdings will eventually rebound in value. In fact, the property in our example was worth $64,000,000 in 2007 just before the market crash.

So, the objective is how to include the current $10,000,000 of equity in the gross estate, obtain an income tax-free basis step-up for the value as offset by the $44,000,000 and shift all future appreciation in value out of the gross estate? The solution is the preferred partnership freeze described next.

C. Use of the Preferred Partnership Freeze

Although the above example assumed that Senior owned the real estate as an individual, today all real estate is generally owned in partnership form, either as a limited partnership or as a limited liability company. Using the same example as above, assume for illustrative purposes that the real estate is owned by a partnership and for simplicity purposes assume that the partnership is a limited partnership with Senior as the sole limited partner and that the general partner is a management company that receives a guaranteed payment in return for services. Thus, the partnership balance sheet is as follows:

PARTNERSHIP BALANCE SHEET

Asset	Basis	Value	Liabilities	Value
Real Estate	$4,000,000	$54,000,000	Mortgage	$44,000,000
			Capital	
			Limited partner	$10,000,000
			General partner	Zero
Totals		**$54,000,000**		**$54,000,000**

45 § 1(h)(D)(1)(i).

During 2007, when the real estate was worth $64,000,000, the partnership refinanced the real estate, obtaining the current $44,000,000 mortgage and using $32,000,000 of the refinancing to pay off the old mortgage. The partnership then distributed the remaining $12,000,000 as an income-tax-free distribution to Senior.

Senior intends to hold the real estate (actually the partnership interest) until his death so as to receive an income-tax-free set up in basis, thereby eliminating all of the $50,000,000 gain, including the $40,000,000 of phantom gain (the so-called negative basis). In addition, Senior expects the value of the building to rebound to its prior level, especially since the building is 100% occupied and is located in an area where commercial rentals are expected to increase in the long term. Because of Senior's concern with the phantom gain, Senior has done no estate planning for this partnership interest and intends to hold the real estate (actually the partnership interest in the partnership that owns the property) until his death. The disadvantage of this approach is that all subsequent appreciation will be included in Senior's estate at death.

Using a preferred partnership freeze under § 2701, Senior can shift all future appreciation in value without any gift or estate taxes and still obtain an income tax-free step-up in basis at death for all, or at least 90% of the phantom gain as well as the remainder of the built-in gain.

Pursuant to § 2701, Senior will recapitalize the partnership into preferred and common limited partnership interests. The tax benefits of the preferred partnership structure are two-fold. First, all subsequent appreciation in excess of the current $54,000,000 of value must be allocated to the common interest and the common interest can be shifted out of Senior's estate without any estate tax on that future appreciation. Second, by retaining a preferred partnership interest, 90% of the phantom gain, and up to 90% of the "equity" gain, can receive an income-tax-free step up in basis at death.

Solution #1:

Convert the $10,000,000 of partnership capital held by the limited partner into a preferred capital account representing 90% of the capital and a common capital account representing 10% of the capital.

PARTNERSHIP CAPITAL ACCOUNTS

Partner	Tax Basis[46]	Gross Value	Liability[47]	Phantom Gain	Capital

[46] § 704(c). The regulations require that all of the built-in gain must be allocated to the partners who were partners at the time the built-in gain occurred, commonly referred to as a "reverse § 704(c) allocation." Treas. Reg. §§ 1.704-1(b)(4)(i) and 1.704-3(a)(6)(i).

					Account
Preferred (90%)	$3,600,000	$48,600,000	$39,600,000	$36,000,000	$9,000,000
Common (10%)[48]	$400,000	$5,400,000	$4,400,000	$4,000,000	$1,000,000
Totals	**$4,000,000**	**$54,000,000**	**$44,000,000**	**$40,000,000**	**$10,000,000**

Senior retains ownership of the preferred interest and disposes of the common interest by a transfer of the common interest to a grantor trust[49] for the benefit of junior family members. By making a gift to a grantor trust, there is no gift for income tax purposes and therefore no income tax liability shift.[50] Alternatively, the disposition of the common interest can be by an installment sale to the grantor trust. Under the partnership agreement, all subsequent appreciation in the value of the real estate is allocated to the common interest.

When Senior dies, the preferred limited partnership interest is an asset included in Senior's gross estate. Since the preferred interest is a limited partnership interest, it is eligible for a valuation discount. But, for now, assume that the preferred limited partnership interest is valued in Senior's gross estate at $9,000,000 (no valuation discounts are taken) when Senior dies. That preferred partnership interest has the following characteristics:

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account

47 Treas. Reg. § 1.752-3. Likewise, the partnership liability allocation regulations require that the liabilities creating the reverse § 704(c) allocation also be allocated to the same partner who was allocated the reverse § 704(c) gain. Treas. Reg. § 1.752-3(a)(2).

48 Section 2701(a)(4) requires a minimum valuation for the junior or common interest to be at least 10% of the values for all of the capital accounts.

49 If the gift is to Junior directly, or to a non-grantor trust, then there would be a liability shift for income tax purposes, and gain would be realized and recognized to the extent the liability exceeded the basis in the gifted asset. *See* §§ 1001 and 1015. In other words, this would be a part-sale, part-gift, causing the realization and recognition of $4,000,000 of gain ($4,400,000 of liability in excess of $400,000 of basis for the common interest). Thereafter, the donee's basis in the common interest would be $4,400,000. *See e.g. Guest v. Commissioner*, 77 T.C. 9 (1981), *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986), *Diedrich v. Commissioner*, 457 U.S. 191 (1982). *See, also,* Rev. Rul. 81-163, 1981-1 C.B. 433.

50 *Cf*. Rev. Rul. 81-98, 1981-1 C.B. 40 (gift of installment note to a grantor trust is not an early disposition under § 453B); Rev. Rul. 85-13, 1985-1 C.B. 184; and P.L.R. 2004-34-012 (April 23, 2004) (followed Rev. Rul. 85-13, holding that there was no income tax realization event for income tax purposes upon the sale of an appreciated asset to a grantor trust). See Hesch and Manning, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Management Estate, Gifts and Trusts Journal 3 (1999).

Preferred (90%)	$3,600,000	$48,600,000	$39,600,000	$36,000,000	$9,000,000

The total potential gain in the preferred interest is $45,000,000 (of which $36,000,000 is phantom gain). Using the $9,000,000 value (no valuation discounts are taken) for the preferred partnership interest included in the gross estate, the estate's income tax basis in the preferred partnership interest will be $48,600,000 (includes the $39,600,000 of liabilities allocated to the preferred interest). Since the estate's $48,600,000 basis (outside basis) in its partnership interest exceeds the $3,600,000 share of the partnership's basis (inside basis) in the real estate, the § 743(b) special basis adjustment is $45,000,000, thus eliminating 90% of the phantom gain, and 90% of the remaining gain, at a very modest estate tax cost. And, all of the future appreciation has been shifted to the common interest.
Using a 40% estate tax rate, the estate taxes on $9,000,000 are $3,600,000. This estate tax cost is far less than the income taxes on the $45,000,000 of income tax gain eliminated by including the preferred interest in the gross estate.

If there was a gift of the common interest to a grantor trust, the common interest is not included in the gross estate and the $4,400,000 of gain inherent in the common interest at the time Senior transfers it by gift remains exposed to the income tax.[51] That common partnership interest has the following characteristics:

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Common (10%)	$400,000	$5,400,000	$4,400,000	$4,000,000	$1,000,000

Alternatively, Senior can sell the common interest to a grantor trust for a $1,000,000 installment note (again, assuming no valuation discounts). If Senior dies while the grantor trust's entire $1,000,000 note obligation is outstanding, upon Senior's death, the trust becomes a non-grantor trust for Federal income tax purposes. Upon the conversion of the trust, which occurs simultaneously with the grantor's death, Senior is treated for income tax purposes as transferring the encumbered common partnership interest by reason of death. Since a transfer of property subject to a liability by death is not an income tax realization event, none of the $4,000,000 built-in gain inherent in the common interest is reported, and the trust, which is now a non-grantor trust, takes a $5,400,000 income tax basis in the common interest, creating another $5,000,000 § 743(b) special basis adjustment.[52]

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[51] §§ 671-677.

[52] When the grantor dies with the promissory note outstanding, the promissory note is an asset included in the grantor's gross estate at its fair market value. The contentious issue is whether there is a taxable transfer at the time of death for income tax purposes by the grantor to the family trust of the property originally "sold" to it, because it is transferred subject to the obligation of the promissory note. The better view is that the transfer at death should not result in recognition any more than a transfer of

If the preferred limited partnership interest is discounted, the discount does not change the amount of phantom gain that can be eliminated by inclusion of the preferred interest in the gross estate. Since the discount only reduces the value of the preferred limited partnership interest included in the gross estate, the discount only reduces the income tax step-up in basis for the value of the $9,000,000 of equity in the preferred interest.[53] For example, if the preferred interest was valued in the gross estate at a discounted value of $6,000,000, the estate's income tax basis would be $45,600,000 ($6,000,000 + $39,600,000) and the § 743(b) special basis adjustment would be $42,000,000. So, the $1,350,000 reduction in estate tax resulting from the $3,000,000 valuation discount (45% x $3,000,000 = $1,350,000) must be compared to the $3,000,000 additional income tax gain that may be eventually reported.

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property to the estate subject to an obligation owed to a third party secured by a mortgage in an amount in excess of the decedent's basis in the property results in gain recognition. Death is simply not a realization event. Thus, because the termination is at death, the decedent does not realize taxable gain on any excess of the balance of the tax amount of the note over the basis of the property transferred. Similarly, there is no income in respect of a decedent ("IRD") under § 691 because there was no gross income prior to death. IRD is defined as income realized while the decedent was alive but not reported while alive because of the decedent's method of accounting. Since the initial "sale" to the family grantor trust was not a realization event for income tax purposes, it cannot satisfy the terms of § 691(a). Several commentators agree that the termination of grantor trust status as a result of the grantor's death while the promissory note is outstanding does not ; result in the realization of the gain inherent in the assets initially transferred to the grantor trust. See Gans and Blattmachr, *No Gain At Death*, 149 Trusts & Estates 34 (February 2010); Aucutt, *Installment Sales to Grantor Trusts*, 4 Business Entities 28 (March/May 2002); Blattmachr, Gans and Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 Journal of Taxation 149 (September 2002) and Hesch and Manning, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Management Estate, Gifts and Trusts Journal 3, 21-26 (1999). Other commentators have reached a different conclusion without addressing the application of the principle developed by the Supreme Court in *Crane v. Commissioner*, 331 U.S. 1 (1947) that death is not an income tax realization event when an encumbered asset is transferred by reason of death. See Cantrell, *Gain Is Realized At Death*, 149 Trusts & Estates 20 (February 2010); Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 journal of Taxation 49 (July 2001); Peebles, *Death of an IDIT Noteholder*, 144 Trusts and Estates 28, 32-33 (August 2005); Hodge, *On the Death of Dr. Jekyll – The Dispostion of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 Tax Management Estate, Gifts and Trusts Journal 275, 283-284 (Nov. 11, 2004). An unofficial administrative position taken by the IRS appears to support the position that there is no gain at death. See C.C.A. 2009-23-024 (December 31, 2008). ***Caution**: The IRS may rely on a technical reading of the language in Treas. Reg. §§ 1.443-1(a)(2) and 1.691(a)-1(b) where for determining a decedent's last tax year it states that the decedent's last tax year runs from January 1 to 11:59 pm for the day of decedent's death. The instructions to Form 1041 provides that the moment of death determines the end of a decedent's tax year and the beginning of the estate's tax year. Can it be inferred from this that on the date of death, the estate comes into existence after the actual time of the day that the decedent died? The IRS may try to apply Section 1015(b), but should not prevail as that section only applies to lifetime gratuitous transfers and this is a gratuitous transfer at death.*

[53] § 1014(a).

Solution #2:

This alternative can be used if the real estate owner has other assets that can be contributed to the real estate partnership. Assume the following revised facts:

PARTNERSHIP BALANCE SHEET

Asset	Basis	Value	Liabilities	Value
Real Estate	$4,000,000	$54,000,000	Mortgage[54]	$45,000,000
			Capital	
			Senior	$9,000,000
Totals		**$54,000,000**		**$54,000,000**

As part of the recapitalization of the partnership into preferred and common partnership interests, Senior will make an additional capital contribution. Assume that Senior contributes $1,000,000 of cash[55] for a common partnership interest and that the existing $9,000,000 of capital is converted to a preferred interest with a priority return. Since all of the built-in gain, including all $41,000,000 of the phantom gain (affectionately known by partnership types as "minimum Section 704(c) gain"), must be allocated to Senior's preferred interest, Senior's retention of the preferred interest as an asset in the gross estate upon Senior's death eliminates all of the $50,000,000 of built-in gain.[56] The key planning aspect here is that under the partnership liability allocation Regulations, none of the existing $45,000,000 of liabilities can be allocated to the common interest.

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Preferred (90%)	$4,000,000	$54,000,000	$45,000,000	$41,000,000	$9,000,000
Common (10%)	$1,000,000	$1,000,000	None	None	$1,000,000

54 The amount of the mortgage for this example was increased to $45,000,000 so that the example can use even numbers.

55 The additional capital contribution can be an asset other than cash and can be an appreciated or a loss asset since the basis in the contributed asset is not needed. All that is necessary is that the contributed asset is valued at $1,000,000 for capital account purposes. *See* Treas. Regs. § 1.704-3.

56 Treas. Reg. § 1.704-3(a)(1).

Now, Senior can dispose of the common interest, either by gift to a any trust or by a deferred payment sale to a grantor trust. Since none of the liabilities are allocated to the common interest, the common interest can be gifted to an individual or to a non-grantor trust without creating a part-sale/part-gift income tax gain event. With regard to the elimination of the phantom gain at death, it does not matter if the retained preferred interest at death is discounted. If the preferred interest is valued at $9,000,000, the § 743(b) special basis adjustment is $50,000,000. If the preferred interest is discounted and valued at $6,000,000, the § 743(b) special basis adjustment is $47,000,000. Thus, the entire $41,000,000 of phantom gain is eliminated at death regardless of the value of the preferred interest in the gross estate at death.

Alternatively, the $1,000,000 capital contribution in exchange for a common limited partnership interest can be made by someone other than Senior, such as a child.

Can the value of the capital account for the preferred partnership interest be discounted for lack of control if Senior contributes a limited partnership interest in an existing family limited partnership that already owns the real estate to a newly-formed family limited partnership in exchange for a preferred interest in the new family limited partnership, using the discounted value of the existing family limited partnership interest as the capital contribution to the new family limited partnership? If the new family limited partnership was created principally for the purpose of creating discounts, the Regulations promulgated under § 2701[57] provide that for capital account purposes, the voting rights of all family members will be aggregated for purposes of determining the value of a non-voting interest. Interestingly, this Regulation was adopted before the IRS conceded this aggregation approach in Rev. Rul. 93-12.[58] Therefore, there is considerable doubt that this Regulation's requirement that all family-held interests must be aggregated continues to apply. If the limited partnership interest is in an existing commercial partnership that owns the encumbered real estate, it appears that a lack of control discount will be permitted for commercial limited partnership interests.[59]

None of the commonly-used freeze techniques, such as a gift, the GRAT and the installment sale to a grantor trust, offer the income tax advantage offered by the preferred partnership freeze. Only with the preferred partnership freeze will there be certainty as to the

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57 Treas. Reg. § 25.2701-3(b)(1)(i) provides that "The fair market value is determined by assuming that the interests are held by one individual, using a consistent set of assumptions."

58 In *Estate of Bright v. United States*, 658 F.2d 999 (5th Cir. 1981), the court rejected this aggregation approach for interests owned by family members. The IRS finally accepted the holding in *Estate of Bright* in Rev. Rul 93-12, 1993-1 C.B. 202.

59 P.L.R. 96-39-054 (July 21, 1996) indicates that there is no look through if the partnership owning the real estate is not a family entity.

ability to obtain a basis step-up upon death for low basis leveraged assets which have liabilities in excess of basis. Unfortunately, the preferred partnership freeze technique is often overlooked because it presents significant complexities. And, since the return that must be paid on the preferred partnership interest cannot be tied to the AFR, the economics of the freeze partnership can be a challenge to the planner.