Proskauer

Estate Planning for Real Estate Owners

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Introduction

Real estate owners are prime estate planning candidates. Without proper planning, an owner's family can be left to pay significant estate tax without liquid assets to make the payment. Even though that tax can often be paid over a 14-year period, the cash flow needed to make those tax payments can significantly reduce cash available to provide for the family.

Also, real estate owners often spend much of their careers accumulating prime real estate assets that are irreplaceable. If such assets need to be sold to pay estate tax, the owner's efforts in putting together a prime real estate portfolio are lost. With proper estate planning, however, those assets can be maintained for future generations.

The Tax Rules

Everyone is taxed on what they own when they die. There are only two ways to reduce that tax: own less, or make what you own worth less. Real estate owners are uniquely situated to do both.

Under current law, everyone can give away (or die owning) $11,580,000 of assets without incurring gift (or estate) tax. A married couple can give away twice that amount, or $23,160,000. That amount – the exemption amount – is scheduled to be cut in half in 2026. And as local and federal governments struggle with significant budget shortfalls as a result of the pandemic and record unemployment, there may be pressure and proposals to quickly cut the gift and estate tax exemption in 2021 after the 2020 national elections. Therefore, taxpayers may be wise to "use or lose" that bigger exemption amount as soon as they can. Though there was initial concern, the IRS has already said that use of the bigger exemption amount now will not be "clawed back" later.

It's always better to make gifts when assets are at the "low end" of their values, rather than at the "high end". In essence, if a real estate owner had a property worth $15,000,000 that is now worth $11,580,000, he could give the entire property away within the amount of his or her exemption amount. On the other hand, if the gift was made when the property was worth $15,000,000, the $3,420,000 in excess of the exemption amount would be taxed at 40%. In this example, if the gift is made at the high end, $1,368,000 of gift tax would be due.

Present Circumstances Create a "Perfect Storm" to Allow Real Estate Owners to Estate Plan

Currently, COVID-19 has had a negative impact on the commercial real estate market. Owners of hotels have seen significant declines in revenues – shelter at home orders significantly reduced travel, and social distancing required in order to re-open keeps hotels well below capacity. Owners of shopping centers have seen revenue declines as well – first, because their properties were closed; second, because during the closure many tenants became insolvent; third, because of the general hurt on the spending public, it is unlikely that traffic and purchases will rebound for many years. Owners of office space likely saw rent defaults as businesses became insolvent, and as people have learned they can successfully work from home it is unclear that the commercial office market will ever rebound in full. Owners of apartment buildings have not received full rents as tenants who are out of work cannot pay their rent on a current basis.

For these reasons, real estate owners are at the "low end" when it comes to valuing properties that they want to gift. Appraisers are providing "COVID discounts" for real properties in the range of 15% - 30%, depending on the type of property. Now is the time to make gifts of real estate.

In reality, real estate owners remain confident that the market will ultimately rebound. After all, land is the one commodity that there is a fixed amount to acquire. Whether that rebound takes 1, 2 or 3 years, eventually properties are expected to return to their pre-COVID values. But making gifts now – especially when uncertainty is at its highest – is an opportunity to take immediate action while they still can.

Real estate owners have another advantage with respect to estate planning – they most often own their assets inside entities. With proper planning, this permits owners to make gifts of their interests in entities while taking discounts for "lack of control" and "lack of marketability". Appraisers typically provide these discounts in the range of 30% - 40%.

Assume that a real estate owner holds a building worth $18,000,000 in an LLC. He owns a 1% managing member interest in the LLC and a 99% non-managing member interest in the LLC. A gift of his 99% non-managing member interest in the LLC can come along with a 30% discount. In that case, the gift would be 99% x $18,000,000 x 70% = $12,474,000.

But what if a 15% COVID discount is available for the $18,000,000 property? Now that property is worth $15,300,000. Coupling the COVID discount with the 30% discount for lack of control and lack of marketability, the gift would be $15,300,000 x 70% = $10,710,000. *That is less than the real estate owner's exemption amount.* In effect, the real estate owner can give away an $18,000,000 building for $10,710,000. The immediate transfer tax savings is 40% of the spread, or $2,916,000.

Like the exemption amount, the lack of control and lack of marketability discounts could also be eliminated after the November elections. Proposed regulations to eliminate such discounts in 2016 were withdrawn. It is no secret that the IRS detests these discounts; thus, there is reason to believe due to a lack of revenue, government officials will try to eliminate their use at its earliest opportunity. Using these discounts in 2020 before losing them, therefore, is more important than ever.

What if a real estate owner wants to transfer the appreciation on the value of assets in excess of his or her exemption amount, without paying immediate gift tax? That owner can sell assets to a "grantor trust" to accomplish that end.

A "grantor trust" is a trust that is treated as the grantor (the person who establishes the trust) for income tax purposes. Therefore, if a real estate owner establishes the grantor trust and sells assets to it, he or she is treated as selling assets to him or herself. As a result, *there is no gain or loss on the sale*.

That sale is typically done in exchange for a promissory note. The cash flow from the asset sold is used to service the debt. The IRS imposes a certain minimum interest rate that must be charged on such notes in order to avoid adverse gift tax consequences. That interest rate is referred to as the applicable federal rate, or "AFR". The effect of the AFR is to set the "hurdle rate" that the assets purchased by the grantor trust must out-earn in order to transfer appreciation on a gift tax-free basis to the grantor trust. When the AFR is low, more appreciation can be transferred to the real estate owner's heirs without transfer tax consequence.

In August 2020, the AFR is at historic lows. For example, if the property is sold on a 9-year note, the AFR (or hurdle rate) is 45 basis points. If the property is sold on a note that exceeds 9 years, the AFR (or hurdle rate) is 1.17%. As a result, not only can real estate owners gift their discounted real estate entities to trusts for children, they can also sell those discounted entities to grantor trusts in exchange for promissory notes bearing these low interest rates.

Assume the same 99% non-managing LLC interest owning the $18,000,000 property described above. Through discounts, that 99% interest is worth only $10,710,000. If the real estate owner sells that asset to a grantor trust in exchange for a 9-year interest only note, the grantor trust only need pay the grantor $48,195/year. Assume, however, that the net income from the property is $750,000/year. After paying the $48,195 of interest to the grantor, the trust keeps $701,805/year. Over 9 years, the trust accumulates $6,316,245. The gift tax saved is 40% of that, or $2,526,498. *Low AFRs create a unique opportunity to transfer cash flow from properties to trusts for children without gift tax.*

The grantor trust concept sounds too good to be true. Not only does it allow the grantor to engage in tax-free transactions with the trust, but it also allows the grantor to pay income tax on the trust's income. That is effectively a transfer from the grantor's assets to the trust, but because the grantor trust rules define the income tax paid with those assets as the grantor's income tax, *the grantor is not treated as making a gift to the trust for gift tax purposes.* However, the entire grantor trust concept may be at risk; in fact, there were budget proposals during President Obama's tenure to eliminate the benefit of grantor trusts. Many expect that this idea of eliminating the benefits of grantor trusts will resurface in 2021.

Truly Dynastic Estate Planning for Real Estate Owners

Gifts or sales to trusts for family members allow the assets of those trusts to be properly administered for beneficiaries in the future. If properly planned, assets of those trusts can pass not only from the real estate owner to his or her children, but also on to his or her grandchildren by taking advantage of the generation-skipping transfer tax exemption. (When the generation-skipping transfer tax exemption is used it doesn't mean that the *benefit of the assets* skips a generation – only that the *estate tax* on those assets skips a generation.)

However, in most states, trusts can only last for about 100 years. While in the trusts the assets can pass from generation to generation without estate tax, but at the end of the 100 years when the trusts terminate, the assets will again be subject to those taxes.

There are certain states (e.g., Delaware, South Dakota, Wyoming) that have a different rule. In those states, trusts can literally last forever. If a real estate owner has truly dynastic assets that he or she wants to keep in the family forever, gifts or sales to trusts that are governed by the laws of the states that don't require trusts to be distributed in 100 years should be employed.

Other Concerns for Real Estate Owners

Even though the estate planning opportunities are great, real estate owners have a unique set of other concerns that must be addressed in the context of undertaking these approaches. All are important, none are unsurmountable.

Lender Concerns

If there are loans on the properties, some of these transactions may require lender notification. Others may require lender consent (though many loans carve out estate planning transfers from being treated as events of default). A careful review of loan documents before proceeding is recommended.

Property Taxes

In California, property taxes can be reassessed resulting from the "changes in ownership" that result from these estate planning techniques. With careful planning (e.g., not transferring more than 50% of an interest in an entity to any one new owner where the property was initially acquired by the entity) this adverse consequence can often be avoided.

Retention of Control

No real estate owner wants to transfer ownership and give up control of the property owned by the real estate entity. Recapitalizing the entity into controlling and non-controlling interests allows for such transfers without an interruption in control if only the non-controlling interests are transferred.

Cash Flow Questions

If the real estate owner depends on the cash flow from a property, a gift of that property may not work – though good from an estate planning perspective, if it leaves the owner without enough cash to live his or her life, these techniques are unappealing. There are options, however, to address this concern.

First, the asset could be given to a trust for the real estate owner's spouse (a spousal lifetime access trust, or "SLAT"). Income could be accumulated in that trust in order to ultimately pass to the real estate owner's children; however, if funds were needed, the trustee of the SLAT could distribute cash to the owner's spouse and he or she could use those distributions to support the couple's lifestyle. Of course, if the couple divorces, or if the spouse dies before the real estate owner who funded the SLAT, that cash would not be available for the real estate owner.

Second, when selecting assets to be given, those that generate the least cash flow could be selected. That way, the real estate owner's cash flow is reduced the least and perhaps leave him or her enough to live his or her life.

Third, rather than just gifting the asset, a cash flowing asset on which the real estate owner depends could be sold to a grantor trust. Cash flow from the property could be used to service the debt, providing the real estate owner a source of cash to provide for his or her lifestyle. Of course, once the note is paid in full the cash flow would cease – so these issues must be carefully thought through before proceeding.

Loss of the Basis Step-up at Death

Assets owned at death receive a basis step-up equal to fair market value. However, assets given away or sold to grantor trusts do not receive that income tax benefit. So on its face, it looks like one must trade the estate tax savings for the loss of that income tax benefit. Real estate owners hoping for basis step-ups at death might give pause to estate planning suggestions that would make that benefit unavailable.

However, there is still a way to get the benefit of the basis step-up (have your cake and eat it too). If the real estate owner reacquires the assets transferred to a grantor trust (either by buying those assets for cash or by swapping the low basis real estate for higher basis assets owned outside the grantor trust), the low basis real estate will be part of the real estate owner's taxable estate when he dies. Part of the planning process should include a discussion of this alternative.

Conclusions

COVID discounts, lack of control and lack of marketability discounts, and low AFR rates create a perfect storm for real estate owners to pursue their estate plans. In addition, it seems likely that lack of control and lack of marketability discounts will be curtailed or limited after the 2020 election. And with the certain reduction of the exemption amount in 2026, taxpayers must act now or lose the benefits of the highest exemption amount amount in history.

Failure to act now will leave taxpayers viewing 2020 as a year of missed opportunity. A conference with one of the members of Proskauer's Private Client Services Department could be of great benefit. We are available to speak to you about these issues whenever you wish.

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