

# Income Tax Planning for Negative Capital Account Real Estate: Dealing with Phantom Gain

Jerome M. Hesch

Director, Notre Dame Tax & Estate Planning Institute

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South Bend, Indiana

Adjunct Professor of Law

Florida International University

University of Miami

Vanderbilt University

Boston University, On-Line LL.M. Program

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- **Example** The principal asset in Senior's estate is 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 depreciated the entire amount allocated to the building over 18 years, using ACRS. Over the years, Senior was able to take substantial funds out of the building income tax-free by means of periodic refinancing.

## Current status of the real estate

- Gross Value                   \$54,000,000
  - Adjusted basis               \$ 4,000,000
  - Mortgage                     \$44,000,000
  - Equity                         \$10,000,000
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- *Phantom gain* is liabilities in excess of basis, here being \$40,000,000.
  - The potential income tax gain is \$50,000,000.

If the asset is sold subject to the mortgage while Senior is living for 10,000,000 in cash?

<b>Amount realized:</b>	<b>\$54,000,000</b>	<b>(cash \$10,000,000 + mortgage \$44,000,000)</b>
<b>Less: Adjusted basis</b>	<b><u>-4,000,000</u></b>	
<b>Realized gain</b>	<b>\$50,000,000</b>	

Assume Senior lives in a state with a 5% state income tax rate.

<b>Gain</b>	<b><u>Combined income Income tax rate</u></b>	<b><u>Federal and state income taxes</u></b>
\$16,000,000 ordinary income	45%	\$7,200,000
\$34,000,000 capital gain	25%	\$8,500,000
Total income taxes due		\$15,700,000

## If the asset is not sold and is subject to estate tax?

- The advantage of including the asset in the gross estate 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 on \$10,000,000 of equity, the Federal 40% estate tax eliminates \$15,700,000 of income taxes if the property is to be sold after Senior dies.

# Property continues to be held

- 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 (if the Federal estate tax applied) creates a basis and the basis allocated to the building can be depreciated over 39 years (over 27½ years if the 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 additional taxes over the depreciable recovery period. Thus, the present value of those future ordinary deductions must be taken into account. If \$40,000,000 is allocated to the building, a 45% combined income tax rate saves \$18,000,000 in future Federal and state income taxes.

Obstacle if Senior continues to retain ownership of the entire real estate asset until death?

If the real estate continues to appreciate in value, that entire appreciation in value will be exposed to the estate tax

# The preferred partnership as an estate freeze solution

Section 2701 permits the owner of an asset to bifurcate the asset between a preferred interest and a common interest if at least 10% of the capital account value is allocated to the common interest. Since all future appreciation is allocated to the common, one can dispose of the common interest to a grantor trust by gift or by an installment sale. And, keep the preferred in the decedent's gross estate. The objective is to keep the phantom gain in the gross estate.



# *The Preferred Partnership Freeze*

## PARTNERSHIP BALANCE SHEET

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>	<u>Value</u>
Real Estate	\$4,000,000	\$54,000,000	Mortgage	\$44,000,000
			<u>Capital Senior</u>	<u>\$10,000,000</u>
				<b><u>\$54,000,000</u></b>

# Alternative #1

## PARTNERSHIP CAPITAL ACCOUNTS

<b>Partner</b>	<b>Tax Basis</b>	<b>Gross Value</b>	<b>Liability</b>	<b>Phantom Gain</b>	<b>Capital Account</b>
Preferred (90%)	3,600,000	48,600,000	39,600,000	36,000,000	\$9,000,000
Common (10%)	<u>400,000</u>	<u>5,400,000</u>	<u>4,400,000</u>	<u>4,000,000</u>	<u>\$1,000,000</u>
<b>Totals</b>	<b>4,000,000</b>	<b>54,000,000</b>	<b>44,000,000</b>	<b>40,000,000</b>	<b>10,000,000</b>

# PARTNERSHIP CAPITAL ACCOUNTS

<u>Partner</u>	<u>Tax Basis</u>	<u>Gross Value</u>	<u>Liability</u>	<u>Phantom Gain</u>	<u>Capital Account</u>
Preferred (90%)	\$3,600,000	\$48,600,000	\$39,600,000	\$36,000,000	\$9,000,000

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

# Alternative #2

## PARTNERSHIP BALANCE SHEET

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>	<u>Value</u>
Real Estate	\$4,000,000	\$54,000,000	Mortgage	\$45,000,000
			<u>Capital</u> Senior	<u>\$9,000,000</u>
				<b><u>\$54,000,000</u></b>

- Senior contributes \$1,000,000 of cash for a common partnership interest and the existing \$9,000,000 of capital is converted to a preferred interest with a priority return.
- The priority return cannot be the AFR. Instead, Rev. Rul. 85-120 requires a market rate similar to preferred stock, and will always be higher than the AFR.

<u>Partner</u>	<u>Tax Basis</u>	<u>Gross Value</u>	<u>Liability</u>	<u>Phantom Gain</u>	<u>Capital Account</u>
Preferred (90%) <b>8% priority allocation</b>	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

Only the preferred interest is included in the gross estate

Although the preferred partnership interest has a \$9,000,000 capital account value, there is a discount for lack of control and lack of marketability. Assume the value of the preferred interest can be discounted by 40% and is valued in the gross estate at only \$5,400,000.



The estate's income tax basis includes the \$5,400,000 value for the limited partnership interest **and the entire \$45,000,000 of liabilities**, for a Section 1014 income tax basis of \$50,400,00.

Have eliminated the entire \$40,000,000 of phantom gain and \$5,600,000 of the gain inherent in the equity (\$5,400,000 of the \$9,000,000 capital account). So, \$3,600,000 of future gain is still exposed to the income tax.

# Borrowing basis from other assets to shift the phantom gain to another asset

## Partnership balance sheet

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>
Real estate	200,000	1,000,000	600,000
			<u>Capital</u>
			<u>400,000</u>
			<u><u>1,000,000</u></u>

Senior's basis in her partnership interest is \$200,000. If Senior sells her partnership interest for \$400,000 cash, Senior will report an \$800,000 gain.

How one can defer the reporting of the phantom gain if a lifetime sale of the negative basis real estate is contemplated.

The income tax deferral will become even more important if there is no estate tax and no income tax-free step-up in basis at death.

Senior contributes stock with a basis and value of \$400,000 to the partnership.

*Partnership balance sheet*

<u>Asset</u>	<u>Basis</u>	<u>Value</u>	<u>Liabilities</u>
Real estate	200,000	1,000,000	600,000
Stock	400,000	400,000	
			<u>Capital</u>
			<u>800,000</u>
			<u>1, 400,000</u>

Senior's outside basis is now \$600,000. Now, Senior's allocable share of partnership liabilities no longer exceeds Senior's outside basis.

Result if Senior sells the partnership to a complex (non-grantor) trust for an \$800,000 installment note, payable interest only with a note maturity of 20 years?

**Gross profit ratio** = gain ÷ **contract price**.

**Contract price = sale price less liabilities = \$1,400,000 less \$600,000 = \$800,000**

**Gross profit ratio** = \$800,000 ÷ \$800,000 = 100%.

Since all basis in the partnership interest was allocated to the liabilities, that leaves no basis for the installment note. Hence a 100% gross profit ratio. *The trust's basis in its partnership interest is a cost basis of \$1,400,000.*

After waiting for 24 months (see § 453(e), the anti-*Rushing* rule), the trust resells the partnership interest for \$825,000 cash. The trust's gain on only \$25,000.

Amount realized	\$1,425,000	(cash \$825,000 + mortgage \$600,000)
Less: Basis	<u>-1,400,000</u>	
Realized gain	<u><u>\$25,000</u></u>	

Since the trust waited for more than two years before reselling the interest purchased from Senior, a related party, Senior can continue to use the installment method to defer Senior's \$800,000 gain until the trust pays the note principal some 18 years later.