Real Estate Planning With Freeze Partnerships: An Alternative Estate Planning Strategy for Leveraged Low Basis Real Estate

By Matthew T. Lee and Steven A. Loeb

Although business or investment held real estate can be a significant driver of wealth accumulation, incorporating an owner's interest in industrial, commercial and/or multi-family properties into a comprehensive wealth plan can present unique challenges. These challenges often involve estate and tax planning for partnership held real estate that is highly leveraged and that has a low basis for income tax purposes. Commonly used wealth planning techniques, including certain types of trusts, may not be viable for partners owning highly leveraged, low basis real estate, and could cause unintended and potentially adverse tax consequences, both during the partner's lifetime and following their death. As an alternative to conventional planning strategies, an owner in a partnership holding long-term real estate might consider a sometimes overlooked solution in seeking to accomplish their highest priority tax, wealth, and succession planning goals: the freeze partnership.

Leveraged Low Basis Real Estate

Leverage is a tool frequently used by real estate owners, whether at the time a property is acquired or during the course of their ownership. In the acquisition phase, leverage originates from financing the property's initial cost through a mortgage. If a property appreciates post-acquisition, an owner may have employed leverage to extract equity from the property through a cash-out refinance. Regardless of the reasoning and timing, it is common for real estate held for investment or business purposes to be encumbered by some amount of debt.

In addition to debt, these properties often have a low basis for income tax purposes relative to their current fair market value. Generally, tax basis is equal to the acquisition cost of a property, adjusted to reflect various expenses and improvements along with certain deductions taken over time, including for depreciation.[1] For this reason, a property acquired and held for a significant period that appreciates in value may have a basis substantially lower than its current value. Even with more recently acquired properties, allowable depreciation deductions under section 167 may have eroded the tax base during the course of ownership.[2] For real estate owners who acquired a property through a like-kind exchange, commonly known as 1031s, it is often the case that their current property, which may be one in a series of several exchanges, has a basis significantly lower than its current fair market value as a result of the owner's election to defer tax recognition.[3]

Highly leveraged and low basis real estate held in an entity taxed as a partnership can result in what is known as negative capital. Put simply, negative capital occurs when the debt on the partnership's property is greater than its tax basis.[4] If that is the case, the property must be planned with care as conventional planning strategies may not be viable and, in some cases, could jeopardize the success of the partner's overall wealth plan.

Negative Capital Real Estate: Sell It, Gift It, or Hold It

As with other assets, real estate owners ultimately have three main options when planning for their property: sell it, gift it, or hold it. If it is negative capital real estate they own, however, their options may be limited by the property's tax attributes.[5]

When debt on a property exceeds its basis, as in the case of negative capital real estate, there can be "phantom gain" upon that property's sale.[6] This can result in the recognition of income taxes that consume a large portion of the net sale proceeds, or worse, taxes that exceed sale proceeds, resulting in taxes without sufficient liquidity to pay them. This often makes the prospect of selling negative capital real estate unattractive or altogether unrealistic.

Families with large real estate holdings often consider gifting properties to their children during their lifetime, usually for estate or succession planning purposes, but this too can create tax traps for the unwary. Although a gift is generally not a taxable event for income tax purposes, that is not true of gifted property that has debt in excess of its basis.[7] If that is the case, the gift could result in gain recognition, meaning the donor could end up paying income taxes from the gift.[8] This makes an outright gift of negative capital real estate unattractive as well.

As an alternative to an outright gift, real estate owners might consider gifting their property to a grantor trust, which generally is not a recognition event for income tax purposes.[9] Although grantor trusts, which include grantor retained annuity trusts (GRATs) and intentionally defec-

tive grantor trusts (IDGTs), can be effective wealth planning tools for this and other reasons, they may be less so with negative capital real estate. While a transfer of negative capital real estate to a GRAT or IDGT may not result in gain recognition at that time because the grantor and the grantor trust are considered the same taxpayer, it is uncertain whether gain would be recognized at some point in the future. When the trust ceases to be a grantor trust and becomes its own taxpayer, which could occur either during the lifetime or upon the death of the grantor, there could be a taxable event at that time.[10] This uncertainty and tax risk makes gifting negative capital real estate to a grantor trust potentially perilous.

Even if gain recognition can be deferred by the use of a grantor trust, this strategy foregoes a critical tax planning opportunity. When property is transferred to an irrevocable trust, like a GRAT or IDGT, as a completed gift, the basis in that property carries over, meaning the trust would have the same low basis in the property as the grantor.[11] If the trust later sells the property, it could incur a substantial gain and the resulting income tax could consume most or all of the net sale proceeds.

To avoid saddling their heirs with a future income tax bill, a person with negative capital real estate might consider holding the property until their death so that it receives a basis adjustment.[12] As a general rule, property held until death receives a basis adjustment equal to its fair market value at the time of an owner's death.[13] This is known as the basis step-up, and it can effectively eliminate unrealized gain on appreciated property. This basis adjustment also applies to real property held inside an entity taxed as a partnership.[14] In cases of negative capital real estate, this basis adjustment can be crucial because it allows an owner's heirs to receive property with a new basis equal to its fair market value upon the owner's death. This could reduce the amount of gain, including phantom gain, that previously made a sale of the property undesirable and could allow the heirs to sell or plan with the property more freely.

Although holding negative capital real estate until death might improve the income tax result for a family, it is not without tax risk because it might expose the property to an estate tax. Currently, a federal estate tax is imposed on estates exceeding the federal gift and estate tax exemption amount, and a number of states also assess separate state level wealth transfer taxes. By holding real estate until death, that property might be subject to one or both of these taxes, which could be subject to 50% or more combined tax rates. This makes holding real estate to obtain the basis step-up potentially costly. In some cases, the estate taxes imposed on the property, whether federal, state, or both, could far outweigh the income taxes saved from the basis step-up, jeopardizing the effectiveness of this strategy as well.

Freeze Partnership: A Possible Solution

In light of the potential tax impact of selling, gifting, and holding negative capital real estate, owners of these properties should consider an alternative strategy: the freeze partnership. Although the freeze partnership generally receives less attention as a planning tool, if properly structured and implemented it can potentially achieve a number of common wealth planning goals, including mitigating exposure to both income and estate taxes.

In its most basic form, a freeze partnership is an entity, whether structured as a partnership or a limited liability company, that has two economic interests: a preferred interest and a common interest. Among other things, the preferred interest typically is entitled to a defined annual payment from the partnership, known as a qualified payment right. This is determined by market appraisal but frequently ranges from 6% to 9% of the value of the preferred interest. The value of the preferred interest should be made by a qualified appraiser and should be based upon economic fundamentals. Particular care should also be taken

in the valuation and structuring to ensure that the cumulative net cash flow preference and dissolution preference are adequate so that there is no deemed transfer or gift to the holders of the common interest.[15] The common interest, in turn, would receive any returns not allocated to the preferred interest along with any growth in the value of the underlying assets. Much of the liabilities also could remain with the preferred interest with proper structuring.

Given this division of the partnership's economics, the bulk of its current value typically is attributed to the preferred interest, with the common interest generally representing a smaller portion of the entity's overall value. In fact, it could be the case that up to 90% of the partnership's value is attributed to the preferred interest, with as little as 10% attributed to the common interest.

A family with negative capital real estate could establish a freeze partnership and contribute their property to it in exchange for the preferred and common interests. By closely adhering to certain partnership tax formalities, this contribution should not be a taxable event, mirroring the non-recognition treatment of a grantor trust.[16]

In a straightforward freeze partnership, the senior family member who establishes the entity can retain the preferred interest and then gift or sell the common interest to a junior family member or a trust for their benefit. If structured as a gift, this would allow the senior family member to take advantage of some or all of their lifetime exemption from federal gift and estate tax. Careful structuring would be required, however, to avoid the application of certain rules that could artificially inflate the value of the gifted interest, potentially using more exemption than is planned or even causing an unintended gift tax.[17]

Having properly structured and implemented the partnership, the senior generation, as holder of the preferred interest, would then be entitled to receive annual distributions from the partnership in the form of qualified payments. Any income that did not pass to the senior generation would flow to the holder of the common interest along with the growth in the value of the partnership, namely appreciation of the underlying real estate.

Freeze Partnership: Benefits and Considerations

The freeze partnership could provide an owner of negative capital real estate with a number of key benefits, both tax and non-tax.

If a senior family member holds the preferred interest in the partnership until their death, the basis in that interest would be stepped up to its fair market value at that time, eliminating some of the negative capital attributes, including phantom gain, and potentially resulting in less income tax on a future sale of the partnership property.[18] If the heirs decided instead to hold rather than sell the underlying real estate, it would also mean they would have a partially refreshed basis from which to depreciate the property, which could also provide income tax benefits for them.

Although retaining the preferred interest could expose it to estate taxes, that should represent only a fraction of the freeze partnership's overall value at the time of the senior family member's death. As noted, growth in the partnership primarily would benefit the holder of the common interest, and years after implementation this may represent an outsized portion of the partnership's value. Much of the aforementioned growth likely would have occurred outside the senior family member's estate and would not be subject to estate tax. This could allow a significant portion of the partnership's value to pass to the next generation without incurring an estate tax.

In addition to mitigating both income and estate taxes, the freeze partnership can provide real estate families with several other benefits, including continued lifetime cash flow to the senior generation. As the holder of the preferred interest, a senior family member would be entitled to receive annual distributions from the partnership in the form of qualified payments.[19] Although other strategies, like GRATs, also provide payments back to the grantor, those would only be for a term of years. Qualified payments, on the other hand, would continue so long as the preferred interest is held, which could be for the remainder of the senior family member's lifetime. Additionally, since the amount of the qualified payment is determined by market factors, it is often higher than payments made under the terms of a GRAT or other leveraged strategy, which are tied to a federally set interest rate that tends to be lower. This makes the freeze partnership particularly compelling for the real estate owners looking to implement a gifting strategy while maintaining cash security for their lifetime.

It is also frequently the case that senior family members who currently own real estate wish to remain involved in the management and day-to-day operations of the property. Where other gifting strategies, including GRATs and IDGTs, might mean relinquishing control altogether, a freeze partnership could allow the senior family member to remain involved in the management of the property. However, at the right time, the freeze partnership also could be a vehicle to transition their ownership and control to the next generation.

As with other planning strategies, the freeze partnership may not be appropriate in all circumstances and for every real estate owner. In weighing the freeze partnership against other planning opportunities, a real estate owner

might keep in mind several considerations. Importantly, for the freeze partnership to perform as intended, the underlying properties should have sufficient cash flow to support the qualified payment right due to the preferred interest holder. Insufficient cash flow from the real estate could risk the potential estate and tax planning benefits of the structure and the strategy as a whole. Another consideration should be whether the amount of the qualified payments, as determined by market analysis, exceed the real estate owner's personal cash flow needs. If that is the case, this strategy may be less successful as a freeze technique, as the surplus cash could increase the real estate owner's taxable estate. It is because of this that the freeze partnership is sometimes known as a "leaky freeze," as it could leak value back into the real estate owner's estate. Lastly, given the strategy's highly technical and complex nature, its overall success may hinge on the ongoing commitment of a real estate owner and their multidisciplinary advisory team to operate and maintain the structure properly and effectively. For this reason, it may be a strategy best suited for real estate owners who have substantial real estate holdings and who have significant tax exposure.

When designing and implementing a wealth plan, owners of investment and business real estate should be mindful of whether they hold negative capital properties and, if so, they might consider the freeze partnership as a potential planning solution. While other conventional planning strategies may be more familiar, the freeze partnership may be the most compelling and effective strategy to help owners of negative capital real estate work towards achieving their short and long-term wealth planning goals.

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Endnotes

1 *See* 26 U.S.C. §§ 1012, 1016.

2 References to a "section" are to a section of the Internal Revenue Code of 1986, as amended ("code"), unless otherwise indicated.

3 *See* 26 U.S.C. § 1031.

4 *See* Treas. Reg. § 1.755-1 (2017).

5 For the purposes of brevity, the tax discussion assumes the low basis real estate is held in an entity taxed as a partnership. In our experience, business and investment held real estate is typically held in entities taxed as partnerships because such structure affords the owners numerous tax benefits.

6 *See* Treas. Reg. § 1.731-1 (1960).

7 *See* 26 U.S.C. § 102(a).

8 *See id.* § 1015.

9 *See generally id.* §§ 671-679.

10 *See* Treas. Reg. § 1.1001-2(a)(4)(v) (1980). *See also* 26 U.S.C. § 752(d).

11 *See* 26 U.S.C. § 1015.

12 *See id.* § 1014.

13 *See Id.*

14 *See id.* § 754.

15 *See* Treas. Reg. § 25.2701-1(a)(2) (as amended in 1994). *See also Estate of Trenchard v. Comm'r*, 69 T.C.M. 2164 (1995).

16 *See* 26 U.S.C. § 721.

17 *See id.* §§ 2701, 2702.

18 *See id.* §§ 754, 1014.

19 *See id.* § 2701.

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