NAEPC
Journal of Estate & Tax Planning

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

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October 26 and 27, 2017
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The Robert G. Alexander Webinar Series
National Association of Estate Planners & Councils
March 8, 2017 3:00 pm to 4:00 pm EST

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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

- *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?

Amount realized: $54,000,000 (cash $10,000,000 + mortgage $44,000,000)

Less: Adjusted basis -4,000,000

Realized gain $50,000,000

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

Gain	Combined income Income tax rate	Federal and state income taxes
$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

Asset	**Basis**	**Value**	**Liabilities**	**Value**
Real Estate	$4,000,000	$54,000,000	Mortgage	$44,000,000
			Capital Senior	 $10,000,000
				$54,000,000

Alternative #1
PARTNERSHIP CAPITAL ACCOUNTS

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Preferred (90%)	3,600,000	48,600,000	39,600,000	36,000,000	$9,000,000
Common (10%)	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**

PARTNERSHIP CAPITAL ACCOUNTS

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

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

Alternative #2
PARTNERSHIP BALANCE SHEET

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

- 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.

Partner	Tax Basis	Gross Value	Liability	Phantom Gain	Capital Account
Preferred (90%) 8% priority allocation	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 (intend to sell while alive)

Partnership balance sheet

Asset	Basis	Value	Liabilities
Real estate	200,000	1,000,000	600,000
			Capital
			400,000
			1,000,000

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.

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

Partnership balance sheet

Asset	Basis	Value	Liabilities
Real estate	200,000	1,000,000	600,000
Other asset	400,000	400,000	
			Capital
			800,000
			1, 400,000

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.*

The partnership does not make a § 754 election so that there is no impact on the inside basis for the partnership's real estate.   This avoids the application of §§ 453(g) and 1239 that apply to sales of depreciable property to related parties.

In order to avoid the application of § 453(e) (commonly referred to as the anit-Rushing rule), the partnership should wait at least 24 months from the date the partnership interest was sold to the related party purchaser (the non-grantor trust).   Explain the anti-Rushing obstacle.   The trust's outside basis for its partnership interest is its $1,400,000 cost. Cost includes all liabilities incurred upon the acquisition of an asset (the $600,000 partnership mortgage and the trust's $800,000 note obligation).

After waiting for the 24 months, there are two alternatives that can be pursued.

Alternative #1. The trust can sell the entire partnership interest for cash.

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

Since the trust waited for more than two years before reselling the partnership interest purchased from Senior (a related party), Senior can continue to use the installment method and continue to defer Senior's $800,000 gain until the trust pays the note principal some 18 years later. Obstacle: The sale will require the sale of the entire partnership interest, which means that the Other Asset is part of the purchase

Alternative #2 After waiting the 24 month safe-harbor under § 453(e), the partnership terminates and distributes all of its assets to its partners as a complete redemption of their partnership interests. The redemption is a second disposition. The basis rules under § 732(b) will then apply.

- Under § 732(b), upon the complete termination of a partner’s interest, the redeemed partner’s outside basis is substituted as its basis for the assets received as a liquidating distribution. So, the redeemed partner’s $1,400,000 outside basis is allocated $1,000,000 to the real estate and $400,000 to the Other Asset. Now, the redeemed partner has a $1,000,000 basis when the real estate is sold subject to the $600,000 mortgage.