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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2916

Date:	**20-Oct-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Keith Schiller: Proposal To Eliminate Discounts for Passive Real Estate Owned by Entities Is Plain Nuts**

"Once again, tax practitioners give their attention to how clients should react to a tax proposal rather than whether that tax proposal, or key elements of it, should exist in the first place.

The House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate owned by an entity eliminates valuation adjustments that were established under fundamental valuation principles, causes partial ownership in which discounts are respected when owned among co-owners to be lost once those co-owners place title in the name of an entity (corporation, LLC or partnership) and will throw into havoc the reference included in most buy-sell and other ownership agreements to fair market value as the standard for determining the payment between the buyer and seller.

We get it. Treasury and the Democrats do not like valuation discounts. After all, they worry about cash and publicly traded securities that do not receive discounts when owned directly yet do indirectly when held in an entity. Partial ownership valuation of real estate, on the other hand, applies fractional interest discounts under basic/non-tax valuation principles. The tax law has merely adopted the non-tax valuation principle. With the Democrat proposal, those discounts will be lost once the co-ownership is transferred to an entity."

Keith Schiller has authored a host of **LISI** newsletters respecting federal estate and gift tax law and the preparation of the Form 706, and returns with commentary that examines the House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate owned by an entity. Keith Schiller, Esq., shareholder of the **Schiller Law Group**, a PLC, of Alamo California, has more than 46 years of experience with taxation, and estate and business succession planning. Keith works with clients, teaches and consults on estate planning, tax compliance, business succession and trust administration. Keith has contributed over two dozen newsletter for LISI. Keith is the author of the award-winning book, Art of the Estate Tax Return — Estate Planning At The Movies® ("706 Art").[i] The book reveals Keith's best practice pointers, his insights from co-teaching with the IRS for greater than thirteen years, and practical recommendations from over a dozen leading practitioners across the country who contributed to the book.

Here is Keith's commentary:

EXECUTIVE SUMMARY:

Once again, tax practitioners give their attention to how clients should react to a tax proposal rather than whether that tax proposal, or key elements of it, should exist in the first place.

The House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate is owned by an entity eliminates valuation adjustments that established under fundamental valuation principles, causes partial ownership in which discounts are respected when owned among co-owners to be lost once those co-owners place title in the name of an entity (corporation, LLC or partnership) and will throw into havoc the reference included in most buy-sell and other ownership agreements to fair market value as the standard for determining the payment between the buyer and seller.

We get it. Treasury and the Democrats do not like valuation discounts. After all, they worry about cash and publicly traded securities that do not receive discounts when owned directly yet do indirectly when held in an entity. (The proposal allows discounts for any passive asset reasonably required for working capital needs of a trade or business.) Partial ownership valuation of real estate, on the other hand, applies fractional interest discounts under basic/non-tax valuation principles. The tax law has merely adopted the non-tax valuation principle. With the Democrat proposal, those discounts will be lost once the co-ownership is transferred to an entity.

Consider this simple example, four people co-own passive real estate worth $4 million total. They have a buy-sell agreement in which transactions of partial interests are at fair market value of the partial interest. Assume that a 25% fractional interest is worth $800,000 after a 20% discount. That very common result is respected under IRC Sec. 2703 since it is based on fair market value and is consistent with common real estate ownership valuation. The four owners want the property to be owned by an LLC for one of many good reasons, including but not limited to creditor protection, save property taxes under state law (such as California) on the transfer of a partial interest, avoid state law partition and keep strangers from ownership. Yet, once the co-ownership is held in an entity, the valuation discounts are lost. Under the Ways and Means proposal, each 25% membership interest is worth $1 million. The forgoing example arises because the proposal directs that (i) the non-business assets are valued without discount; and (ii) the entity value (unless actively traded) is determined without taking into account the value of the non-business assets. If the entity also owns business assets, traditional valuation rules apply to the value of the decedent's/transfer's ownership interest in the entity and traditional rules apply to the valuation of the underlying business assets.

Sour cherry on top. The entity buy-sell agreement that applies fair market value will generate a higher value for the purchase and sale than will fair market value under the bastardized definition of fair market value contained in the Ways and Means proposal. Thus, when the buy-sell entity agreement reaches a price of $800,000 for one-fourth interest in the entity yet the estate or gift tax law calls for a $1 million – non-discounted value—the following result:

1. The seller who receives less under the new proposal's definition of fair market value but identical the fair market value under normal rules for a business entity, may be held to have made a gift to the buyer (unless the ordinary course business exception applies). Anticipate that the IRS will make that argument. In a family setting, count on the IRS asserting that no such exception applies. After all, that is a natural outgrowth of the whole point of the change of the definition for passive real estate owned by an entity.
2. The buyer who pays less under traditional fair market value than the gross estate value when an estate is the seller, will now also be charged with estate tax on the "bargain sale" under traditional estate tax equitable allocation rules. This argument has been made in case law. If the estate tax is charged to the residue, the residuary beneficiaries pay the estate tax on the bargain sale.
3. Civil litigation among entity owners (whether family or not) will be encouraged because of vagueness or inconsistency as to what "fair

market value" will actually mean. Is it a normal valuation principle respected under the laws of states for decades or the new definition in an estate or gift tax setting?

Most significantly, why will real estate owned as a fractional interest (fractional ownership of tenancy in common) become worth so much less than ownership of an identical percentage interest held in an entity that owns the real property? There is no logical reason that is should be, or that it is worth less than the entity interest. In fact, in business terms, entity interests are normally worth less than identical fractional interest percentages due to impact of restrictions in the entity agreement.

This author encourages the readers of this newsletter to contact the following: (1) real estate industry lobbying groups; (2) national and state valuation associations; (3) Senator Ron Wyden, Chairman of the Senate Finance Committee; (4) Senator Joseph Manchin, the leading Democrat for moderate tax policy; (5) Senator Krysten Sinema of Arizona; (6) Senator Mark Kelley of Arizona; and (7) Ranking Senator on Senate Finance, Mark Crapo of Idaho to express their opposition to this proposal.

COMMENT:

Section 138210 of the Ways and Means proposed tax increases for 2021, adds a new subsection (d) to Internal Revenue Code (IRC) section 2031in order to eliminate discounts for certain transfers of non-business property. The new rule will apply to "non-business assets" owned by entities unless they are actively traded per IRC Sec. 1092. The definition of non-business assets under the proposal adopts the passive-asset test for income tax purposes under IRC section 469. As part of the requirements to avoid passive asset classification, the transferor must have materially participated, for which reference is made to the 750 annual hour requirement under IRC section 469(h).

Farmers receive some break in that a taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of IRC section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year. Section 2032A establishes special-use valuation. The exceptions noted allow the estate of a decedent for special-use qualification to have satisfied the material participation rule notwithstanding inactivity by the decedent when in continued receipt of old-age social security benefits, if disabled, or when services are performed by a spouse who received the farm from a prior deceased spouse.

Also, inventory assets and notes and receivables from the sale of inventory assets are treated as assets held by a trade or business (i.e., not passive). Thus, real estate developers who recognize sales of real property as ordinary income do not appear to fall within the scope of the proposed new rule’s elimination of valuation of discounts are underlying assets… at least to the extent of the foregoing exceptions.

The Problem Sought to Be Solved

Treasury has sought for years to eliminate abusive uses of entities, particularly for estate and gift tax purposes, in which passive assets (most particularly publicly traded securities and cash) are transferred to entities and deep discounts arises. The wealthy client walks into the tax professional’s office with $20 million in security and cash value, forms an LLC that receives the $20 million in value; and, once minority ownership interest is achieved the underlying assets are value for a fraction (assume 60% to 75%, perhaps) of their pre- contributed value. Actual results will differ, but the point is made.

The IRS has been successful in narrowing the utility of this approach. First and foremost, the entity must have a substantial and legitimate non-tax purpose. A variety of other internal tests and checks exist, including conduct of the entity on a business-like basis, not making distributions for need and retaining substantial wealth outside of the entity. These are a few of among nearly 30 tests that apply to the successful established of an entity among family members that holds substantial passive or investment-type assets.

In addition, various court cases have made it far most risky to create entities that are challenged under the retained interest rules of IRC section 2036. The taxpayer can be worse off as a result of forming the entity and transferring assets than if that taxpayer had left well enough alone.

Nevertheless, Treasury and the reformers in Congress and the Senate have supported and continue to support a more draconian approach to eliminate the formation and funding of entities with estate or gift tax savings as an encouraged element to that planning. In 2016, Treasury issued a proposed regulatory change to IRC section 2704. That proposal ran into massive opposition (including by this author who organized an editorial published in LISI co-authored by over 20 leading practitioners across the country), over 20,000 opposition contacts from taxpayers and organizations, and even opposition by the Small Business Administration after the American Automobile Dealers Association became involved. However, the 2016 election killed that proposal throughout the prior administration.

The 2021 proposal announced by Ways and Means is the most recent attack. Passage of the tax legislation hinges on a tiny handful of Senators, with Joseph Manchin and Krysten Sinema being the most prominent.

<u>Warning!</u>

Fair market value establishes the foundation for federal estate and gift taxation. Value after all is the measure of what is being taxed. The definition of fair market value is not limited to tax law. It provides a common reference in business agreements. Other definitions of value, such as market value, fair value, book value, adjusted book value among others also exist.

Altering the definition of fair market value undermines a key foundation within tax law and business dealings. For decades, the IRS has encouraged taxpayers to apply the fair market value standard. IRC section 2703 is a prime example. That section commences:

> For purposes of this subtitle, the value of any property shall be determined without regard to—
>
> (1) any option, agreement, or other right to acquire or use the property at a price <u>less than the fair market value</u> of the property (without regard to such option, agreement, or right), or… (*emphasis added*)

This author commonly sees "fair market value" used as the measure for determining the price to be paid under a variety of business agreements. That standard normally includes input from appraisers, and perhaps resolution of differences in opinions among the appraisers. Changing the definition weakens the foundation of a key definition for business transactions and tax law.

Consider what will occur when buy-sell agreements direct use of fair market value. If the Ways and Means proposal is approved and fair market value is defined with reference to estate or gift tax law, the price just increased, yet the ownership interest is still minority. If fair market value is the standard and not referenced to the IRC or regulations, the price is discounted (per the appraisal standard of that term) and the reduced amount is paid. The estate, however, pays estate tax on the non-discounted value relative to the passive asset.

However, nothing gets around that point that when fractional interests are contributed to an entity by the various owners of the real estate, the fractional interests that applied at the pre-contribution level will be eliminated for estate and gift tax purposes relative to the real estate if classified as passive. This scheme disregards that fact that the system is not gamed by contributing the real estate since an underlying discount existed anyway. This is unlike cash or publicly traded securities being contributed. Those assets are either not discounted (cash) or the discount is built into the price (securities on the open market).

Earlier, I used the word “bastardized definition” of fair market value. Using that term in these sensitive times was done with measure and reflection. Its reference is spot on. The proposal mangles the cornerstone of estate and gift tax law and generates a collision with common business operations and sound drafting practice. After all, the selected adjective means, “change (something) in such a way as to lower its quality or value, typically by adding new elements.” That is precisely what is occurring. The foreseeable and unforeseen consequences of this alteration will be massive. It’s existence when applied to co-owned real estate is massive. The real winners will be the appraisal community (which may have to value using two different standards) and the civil and tax litigators (who now get to battle over what fair market value means and in what context).

The author also expects new attacks by the IRS arguing that a tenancy in common is actually a partnership. In Rev. Proc. 2002-22, the IRS announced its ruling standard to determine if a co-ownership was a partnership. Expect the IRS to asset that a tenancy in common is, in fact, a partnership. Is the real estate owned by an “entity” or will a tax-deemed entity rule the day?

Also, anticipate changes in leasing practice from tenant maintenance to ownership maintenance and other ways to increase management activities to achieve the business property threshold.

Entities do not exist solely for estate or gift taxation. In California, common practice is to contribute real estate to an entity, or to have an entity buy the real estate in the first place. This is done to help avoid – or at least defer— property tax increases. Moreover, entities provide a host of non-tax benefits, including privacy, avoidance of state-law partition rights, ease to keep third parties out of the business, limit voting rights, and marital property planning. The new proposal undermines these and other legitimate non-federal tax motivations.

Two movie lines come to mind that may explain why this is occurring. The first is from *Lord of the Flies*: **“**We've got to have rules and obey them.” While that line was uttered in the hope of preserving civilization, the new proposal stems from institutionalized anger that generates excessive rule making. The authors and supporters of this proposal do not respect the use of entities for fundamental business purpose with most real estate holdings, including passive assets.

The other quotation is from *Good Will Hunting* when Robin Williams’s character tells Will Hunting (played by Matt Damon), “You’re just a kid, You don’t have the faintest idea what you are talking about.” Granted, Treasury and the tax authors are not kids. They are well educated adults. However, they do not know what the horrible consequences they are about to inflict. The author suspects that some in Congress and the administration are fully aware of the harm they will be doing to real estate investors and simply do not care. All they see is the elimination of valuation discounts on passive real estate held in entities. They do not understand how business agreements are established and how they operate. They do not care that property owners will be made to pay millions of additional dollars in state property taxes (at least in California) since the proposal chills the use of entity ownership of real estate. They have no regard for the real-world actual impact and application of “fair market value” to resolve pricing for the purchase and sale of entity interests in business agreements. The proposal certainly will have that impact. Worse, the proponents have taken to a harsher extreme their opposition to LLCs, corporations and partnerships that have any connection with gift or estate tax unless except to the extent that the underlying assets are held by a trade or business and material participation rules are met.

Conclusion

While practitioners are business planning and advising clients what do to before the tax law passes, our clients would be bettered if some time is spent to defeat the less reasoned elements of the tax proposal. The elimination of discounts with passive real estate for most entities presents a prime example on which reason and light must be shined.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Keith Schiller

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