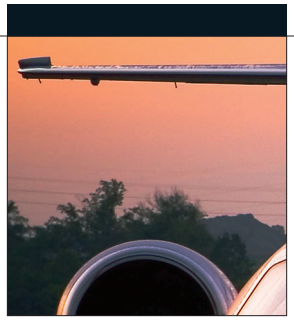

Build Estate Plans With Commercial Real Estate Interests

The entity chosen for holding real estate can have significant tax and nontax implications that should be factored into estate planning arrangements.

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Commercial real estate presents unique opportunities and challenges to the estate planner. Several planning strategies are available to place the appreciation of, or the income generated by, real estate outside the transfer tax system. In addition, because commercial real estate transactions often occur on a fractional basis, valuation discounts may well apply to transfer tax valuation of the interests. Some issues, a portion of which are exclusive to planning with real estate, can derail even a carefully considered plan.

Certainly, the form of ownership through which the real estate operations will be conducted needs to be carefully considered because entity choice can have a significant impact on the planning results. Beyond that, the estate planner is not often first on the scene, and must understand how to deal effectively with existing entities that are less than ideal. This article briefly outlines common estate planning techniques applied to real estate owners and describes the spectrum of entities through which most real estate enterprises are operated. It then ranks how each type of entity stacks up in terms of key tax and nontax concerns, such as liability protection, tax treatment of distributions from the entity, and tax effects of transfers of interests in the entity.

Overview of common techniques

As complex as lifetime wealth transfer planning can seem, boiled down to its essence the planning is quite simple. If an individual attempts to transfer assets during life in order to avoid an estate tax, the transfer will generally be subject to a gift tax instead. Since the gift tax and the estate tax apply at the same rates and generally have the same exemptions, there should be no incentive for an individual to transfer wealth during life as opposed to waiting to transfer it at death. In effect, by enacting the gift tax as a companion to the estate tax, Congress created an "airtight" transfer tax system. There are, however, leaks in that system.

Types of leaks in the transfer tax system. The three primary examples of those leaks are:

1. Removing value from the system.
2. Freezing value within the system.
3. Discounting values within the system.

Removing value from the transfer tax system is hard to do. In most cases, if an individual makes a gift during lifetime, that gift is brought

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back into the taxable estate at death.[1] One key exception to this rule is the annual gift tax exclusion ($14,000 in 2015).[2] Gifts using this exclusion are not brought back into the taxable estate at death.

Freezing value within the system often entails the individual making a gift using some or all of his or her lifetime exemption from federal gift tax. For example, an individual might make a gift to a child of real estate having a value of $5 million. At death, the $5 million gift is brought back into the estate for purposes of calculating the estate tax, but only at its date-of-gift value. If the value of the gifted property increases between the date of the gift and the date of death, the appreciation avoids transfer tax. The value of the property is "frozen" at its date-of-gift value.

A holy grail of estate planners has been to find a way of freezing the value of an asset at some number lower than what it is actually "worth" to the donor's family, commonly referred to as "discounting" values. For example, an individual might own 100% of an LLC holding a rental property worth, say, $15 million. If the individual gives a 50% interest in the LLC to his or her children, the value of the gift should not be $7.5 million. A qualified appraiser would likely apply a discount to reflect the fact that each child receives a noncontrolling interest in the LLC. Assuming for purposes of the example that the discount is 33%, the individual succeeds in freezing the value of the transferred asset at $5 million even though it may be worth $7.5 million to the family as a whole. As a result, even if the real estate never appreciates in value, the family has removed $2.5 million from the taxable estate.

Relevant types of trusts

While the alphabet soup of techniques available to exploit the basic concepts of removing, freezing, and discounting values is almost unlimited, in the world of real estate owners, the most relevant are the spousal lifetime access trust (SLAT), the grantor retained annuity trust (GRAT), and the intentionally defective irrevocable trust (IDIT) sale. Also relevant, but less often used, is the multi-class freeze partnership. The SLAT is one of the authors' favorite examples of a technique that can remove, freeze, and discount values all in one fell swoop.

A grantor in a happy marriage can be comforted to know that his or her spouse will have access to the property in the trust even after the gift.

SLAT. In a typical SLAT, an individual creates an irrevocable trust, naming his or her spouse or some other trusted individual or institution as trustee. During the lives of the individual and the spouse, the trustee is authorized to sprinkle income and principal among a class consisting of the individual's spouse and descendants. Upon the death of the survivor of the individual and the spouse, the remaining trust assets are divided into shares for descendants and held in further trust.

If designed properly,[3] gifts to the SLAT can qualify for the gift tax annual exclusion. As noted above, this removes value from the owner's estate. If desired, the owner could use the trust as a repository for a larger gift using his or her lifetime gift tax exemption, thereby freezing values for transfer tax purposes. If the gift consists of commercial real estate, it should be possible to apply valuation discounts as well.

The SLAT provides other benefits, too. The trust includes the grantor's spouse as a beneficiary. The grantor can never have any legal right to the assets held in the SLAT, nor can there be any prearrangement or understanding between the grantor and his or her spouse that the grantor can use assets in the trust. Nonetheless, a grantor in a happy marriage can be comforted to know that his or her spouse will have access to the property in the trust even after the gift.

In addition, the SLAT would be classified as a grantor trust for income tax purposes, which means that the grantor pays the tax on income and gains earned by the trust.[4] This depletes the grantor's estate, and enhances the value of the trust, but is not treated as a taxable gift,[5] providing a powerful additional means of removing value from the transfer tax system. To the extent that the grantor allocates generation-skipping transfer (GST) exemption to it, the SLAT can be structured as a GST tax exempt trust, thereby removing the gifted assets from the transfer tax system for multiple generations.

A SLAT works well for a gift up to the amount of the owner's gift tax exemption amount ($5.43 million in 2015[6]). But what to do for the client who wishes to transfer more than that but does not want to pay gift tax? For these clients,

1 Under Section 2001(b), "adjusted taxable gifts" are added to the taxable estate in the computation of the estate tax.

2 Section 2503(b); Rev. Proc. 2014-61, 2014-47 IRB 860.

3 This is accomplished by giving each of the trust beneficiaries a "Crummey" right to withdraw from the trust a share of such gifts up to the annual gift tax exclusion.

4 The grantor trust rules are set forth in Sections 671 through 679.

5 See Rev. Ruls. 85-13, 1985-1 CB 184, and 2004-64, 2004-2 CB 7

6 Section 2010; Rev. Proc. 2014-61, *supra* note 2.

the techniques of choice often are the IDIT sale and GRAT.

IDIT sale. The mechanics of the IDIT sale are simple. An individual establishes an irrevocable trust. Although the trust is designed to be excluded from his or her estate for estate tax purposes, it is structured to intentionally "violate" the grantor trust rules for income tax purposes (hence the "defect" in the trust).

The grantor is deemed to own the trust for income tax purposes, with the result that the individual pays tax on the income and gains of the trust just as if those assets were still in his or her own name. The grantor makes a seed gift to the trust of, say, $1 million, using that amount of his or her gift tax exclusion.[7] At a later date, the grantor sells an interest in a real estate entity worth $9 million to the trust in return for the trust's promissory note. The note typically would provide for interest only to be paid for nine years or less. The interest rate on the note is set at the lowest rate permitted by IRS regulations. At the end of the ninth year, a balloon payment of the $9 million principal is due.

Properly structured, the IDIT sale should produce the following tax results:

- The transfer of the real estate should not be a taxable gift because it is a sale at fair market value.
- There is no capital gains tax because a transaction between a grantor and his or her own grantor trust is ignored for income tax purposes.[8]
- Interest payments from the trust to the grantor are not taxable for the same reason.

If the real estate sold to the trust appreciates or produces income at exactly the same rate as the interest rate on the note, the property contributed to the trust will be just sufficient to service the interest payments on the note, and there is no estate tax benefit. If, on the other hand, the real estate does produce a return greater than the hurdle rate, the excess remains in the trust and outside of the grantor's taxable estate.[9]

The threat of a charging order remedy is an important factor that encourages a settlement favorable to the interest owner.

GRAT. A close cousin of the IDIT sale is the GRAT. The grantor gives an interest in a real estate entity to the GRAT, retaining a set annual payment from that property for a set period. At the end of that period, ownership of the property passes to or in trust for the grantor's children or other family members. The value of the taxable gift is the value of the property contributed to the trust minus the discounted present value of the grantor's retained annuity stream, which is calculated using interest rate assumptions provided by the IRS each month. If the GRAT is structured properly, the value of the individual's retained annuity interest can be equal or nearly equal to the value of the property contributed to the trust. In that event, the taxable gift to the trust is zero or near zero.

If the assets contributed to the GRAT appreciate or produce income equal to the IRS hurdle rate, there is no benefit because the property contributed to the trust will be just sufficient to pay the annuity. However, if the assets contributed to the trust appreciate or produce income above the hurdle rate, the excess remains in the trust and outside the grantor's taxable estate. The GRAT is particularly popular for gifts of hard-to-value assets, such as real estate because the risk of an additional taxable gift upon an audit of the gift can be minimized. If the value of the transferred assets is increased on audit, the GRAT can be drafted to provide that the size of the individual's retained annuity payment is correspondingly increased, with the result that the taxable gift always stays near zero.

Multi-class freeze partnership. A potent but less frequently used technique is the "multi-class freeze partnership." The real estate owner drops real estate down into a partnership, taking back preferred and common units. The preferred units come with a set annual distribution right and a liquidation preference. The common units are entitled to all income and appreciation above the preferred distribution hurdle. The common units are typically gifted or sold to an irrevocable trust. As with the IDIT sale and GRAT, if the assets in the partnership produce income or appreciation greater than the hurdle rate (in this case the set distribution accorded to the preferred units), the excess returns pass outside the transfer tax system.

Common entities

Commercial real estate can be owned by a C corporation, S cor-

[7] The idea behind the "seed" gift is to demonstrate that the trust has consequential assets prior to the sale so that the promissory note later issued by the trust to the grantor in connection with the grantor's sale of assets to the trust is debt and not equity. See Ltr. Rul. 9535026; McDermott, 13 TC 468 (1949), *acq.* 1950-1 CB 3.

[8] Rev. Rul. 85-13, *supra* note 5.

[9] At this writing, the IRS had launched two cases in the Tax Court questioning the effectiveness of IDIT sales. It is unclear what result ultimately will come out of these cases or if they will be settled out of court, but planners should be aware of them: Estate of Donald Woelbing v. Comm'r, Docket No. 30261-13, and Estate of Marion Woelbing v. Comm'r, Docket No. 30260-13.

poration, general partnership, limited partnership, or limited liability company (LLC). Occasionally, a client may own commercial real estate individually. Each form of ownership carries with it a set of pros and cons that inform any estate planning analysis. The following paragraphs describe the flexibility and limitation of particular ownership structures and how these attributes shape estate planning.

Owner liability

Limiting liability for operations of commercial real estate should be a significant concern for every owner. Beyond having appropriate insurance in place, a prudent owner will seek to encapsulate exposure so that what happens on owner's parcel A does not put at risk all the other assets on the owner's balance sheet. Individual ownership, or ownership through a general partnership does not encapsulate liability. As a consequence, a damage claim related to an owner's real estate exposes not only the real estate but the personal assets of the owner. Given this potential for disaster, these forms of ownership are almost never recommended for real estate interests.

Preferred entity choices. A significantly more limited exposure is possible if real estate is owned by a limited partnership, LLC, S corporation, or C corporation. Assuming entity formalities are respected and there is adherence to proper administration, only the entity's assets should be subject to a damage claim arising from the entity's real estate. The owner's personal assets are generally not at risk.[10] Although the C corporation, S corporation, limited partnership, and LLC can all provide this protection from liability, the following differences among the entity types should be kept in mind.

A limited partnership is required to have a general partner who will be personally liable for claims against the partnership. Accordingly, an individual acting as the general partner of a limited partnership exposes his or her personal assets to claims arising from partnership operations.[11] Given this, it is critical that the general partnership interest be owned by a corporation or LLC to confine the liability within the entity. The entity of choice to hold the general partnership interest is usually an S corporation or LLC, rather than a C corporation, so that income tax liability at the C corporation level is avoided.

Charging order. Owning real estate through an entity can also provide important protection from claims against an owner unrelated to the real estate. For instance, what happens if an LLC member is subject to a claim unrelated to the operations of the LLC (say, a claim arising from the member's divorce) and the claimant seeks to have the membership interest liquidated or assigned in satisfaction of the claim? Many states limit such a creditor's reach against a limited partnership or LLC interest in such circumstances to what is commonly known as a "charging order."

A charging order grants the creditor only the economic rights associated with the interest having a value equal to the judgment. This means that the creditor does not acquire voting or liquidation rights. Instead, the creditor has a right to receive distributions from the entity.

The practical effect of this remedy is to cause the creditor serious concern because the timing and amounts of such distributions are generally in the discretion of the general partner or LLC manager. Accordingly, the threat of a charging order remedy is an important factor that encourages a settlement favorable to the interest owner. Because remedies are a matter of state law, however, reliance on a charging order remedy can be overdone.

The authors' home state of Connecticut is a case in point. The Connecticut Limited Liability Company Act provides that a charging order is the remedy of a judgment creditor of an LLC member, but fails to expressly state that the charging order is the exclusive remedy.[12] As a result, at least one Connecticut court has determined that in addition to a charging order, the creditor may also be entitled to strict foreclosure on the interest.[13]

The same creditor would find Delaware law considerably less hospitable. The Delaware Limited Liability Company Act expressly states that the charging order is the judgment creditor's sole remedy.[14] Charging order remedies are not applicable to ownership interests in C corporations or S corporations.

Entity flexibility

The attorney developing an estate plan for a client owning entity interests needs to understand and successfully accommodate the wrin-

10 Planners typically recommend holding each parcel of real estate in its own entity. This insulates each parcel from claims involving any of the other parcels.

11 See for example, Connecticut Uniform Limited Partnership Act, Connecticut General Statutes §§ 34-1 to 34-8; § 34-17, which provides that a general partner of a limited partnership has all of the liabilities of a partner in a general partnership. Connecticut Uniform Partnership Act, Connecticut General Statutes §§ 34-300 to 34-399; § 34-327 provides that partners of a general partnership shall be jointly and severally liable for all obligations of the partnership.

12 Connecticut General Statutes, § 34-171.

13 Madison Hills Ltd. P'ship II v. Madison Hills, Inc. 35 Conn. App. 841, 644 A.2d 363 (1994). Under strict foreclosure, the creditor becomes an owner (as an assignee) of the entity. See also Kriti Ripley, LLC v. Emerald Invs., LLC, No. 27277, 2013 WL 3200596 (S.C., 6/26/2013).

14 Del. Code Ann. Tit. 6 § 18-703(d). Charging order is the exclusive remedy available to the creditor, including where the LLC is a single-member LLC.

kles posed by the inclusion of those interests in the client's plan. Essentially, all of the planning the authors do for business owners involves trusts. There is no threshold barrier in transferring C corporation stock, limited or general partnership interests, or LLC membership interests to a trust. But S corporation stock must be held in a trust that does not run afoul of the S corporation qualified shareholder rules. Grantor trusts are permitted S corporation shareholders. Consequently, planning with an IDIT, GRAT, or SLAT can be done with S corporation stock because these trusts are all grantor trusts.

The planner must, however, have an exit strategy because grantor trust status is not permanent. Moreover, some clients do not want to pay income taxes on property they gift to trusts and desire nongrantor status from the outset. Consequently, the planner must understand what types of trusts are permitted shareholders and incorporate these trusts into the plan to prevent an inadvertent termination of the corporation's S election. Two types of nongrantor trusts are permitted shareholders of S corporation stock:

1. The qualified Subchapter S corporation trust (QSST).
2. The electing small business trust (ESBT).

QSST. The requirements of a QSST are:

- All the trust income is, or is required to be, distributed currently to a single income beneficiary.
- The current income beneficiary is a U.S. citizen.
- The trust agreement requires that, during the life of the current income beneficiary, there will be only one current income beneficiary, and the beneficiary's income interest terminates on the earlier of the beneficiary's death or the termination of the trust.
- The trust agreement provides that if the trust terminates during the beneficiary's lifetime, all the trust assets will be distributed to the beneficiary.
- The beneficiary of the trust makes an election.[15]

QSST ownership does not change the income tax pass-through characteristics of the S corporation. The costs associated with this benefit include the requirement that there be only one income beneficiary who receives the income annually. A mandatory income interest is often not what the client would prefer, especially in those cases where one of the purposes of the trust is to provide creditor protection. In addition, the QSST requirements will often prevent the planner from incorporating effective generation-skipping planning.

ESBT. In contrast, ESBTs can serve as generation-skipping trusts, are allowed to have multiple beneficiaries, accumulate rather than distribute income, and sprinkle both income and principle among beneficiaries. ESBTs must meet the following requirements:

- All beneficiaries of the trust must be individuals, estates, charities, and other organizations described in Section 170(c).
- No interest in the trust was acquired by purchase.
- An election is made by the trustee.[16]

The significant drawback to an ESBT is that all of the S corporation income attributable to the trust, excluding only capital gain, is taxed at the highest marginal rate applicable to trusts.[17]

While the C corporation generally is a disfavored entity choice for real estate owner estate planning, the C corporation can have advantages for certain charitable strategies.

While the C corporation generally is a disfavored entity choice for real estate owner estate planning, the C corporation can have advantages for certain charitable strategies. For example, if an owner gives an interest in an LLC, limited partnership, or S corporation to a charitable entity such as a private foundation, the income earned by the real estate inside the entity will be unrelated business income, subject to a 100% excise tax in the foundation. On the other hand, if C corporation stock is used, the unrelated business income tax issue generally is not present. The use of closely held business entities for charitable planning is complex and fraught with numerous other tax risks that are beyond the scope of this article.[18] It should not be undertaken without the advice of a lawyer with deep experience in that area.

Capital structure flexibility

Several planning strategies involve entity structures that include separate ownership classes with varying economic rights associated with

15 Reg. 1.1361-1(j).

16 Section 1361(e).

17 Section 641(c)(2)(A); Reg. 1.641(c)-1(e)(1).

18 For a more detailed discussion, see Daniels and Leibell, "Planning for the Closely Held Business Owner: The Charitable Options," Fortieth Ann. Heckerling Inst. on Est. Plan., Ch. 14 (2006).

each class. Both the LLC and limited partnership provide significant flexibility in terms of how the capital structure of the entity is established. The capital structure of a C corporation is also flexible and can be designed in multiple ways. An S corporation, on the other hand, is prohibited by the tax law from having more than one class of stock (other than classes whose sole variance is in voting rights).[19]

Entity distributions

The effectiveness of many estate planning strategies depends on having cash or asset distributions made from the entity in a tax-efficient manner. Take, for example, the tax effects of distributions necessary in an IDIT sale or GRAT. If the real estate is held in a C corporation, the tax associated with accessing cash to make annual interest or annuity payments can be significant. The corporation must earn income, which is subject to income tax at the corporate level, and then declare a dividend, which is subject to tax at the trust/grantor level, to make the interest or annuity payment. Contrast this with a pass-through entity such as an S corporation, LLC, or limited partnership. Here, tax is paid only at the shareholder, member, or limited partner level.

Occasionally, an estate planning strategy will require a distribution of the real estate itself. This may happen if there is insufficient cash in the entity to make the balloon payment of principal on an IDIT sale note or the annuity payment on a GRAT. The extent to which such a distribution attracts an income tax varies depending on the type of entity owning the property, but the corporate forms generally are disfavored, and the partnership and LLC forms favored. This is so because, generally, appreciated property may be distributed by a limited partnership or LLC to the owners without the recognition of taxable gain,[20] unless the distribution is subject to the "deemed sale" rules.[21] On the other hand, when assets are distributed from an S corporation or C corporation, tax may be assessed.

In an S corporation, taxable gain is recognized at the corporate level when appreciated assets are distributed by the corporation to its shareholders. The gain flows through pro rata to all of the S corporation shareholders. The same tax treatment applies to distributions from C corporations, except that the gain is taxed at the corporate level rather than at the shareholder level.

Planners must consider the issues raised by negative capital when real estate is owned individually, or through an S corporation, limited or general partnership, or LLC.

Real estate and negative capital

Planners must consider the issues raised by negative capital when real estate is owned individually, or through an S corporation, limited or general partnership, or LLC. Negative capital typically results from income tax deductions such as depreciation, or from refinancing debt on the property where the loan proceeds are distributed to the owners—reducing the owners' capital accounts to the extent the cash distributions were derived from nonrecourse borrowings. Upon a disposition of all or part of the owner's interest in the real estate, or in the entity owning the real estate, phantom gain will be recognized to the extent of the negative capital associated with that interest.

While a transfer by an owner to a grantor trust will not cause recognition, such a transfer often represents merely a deferral of recognition. If grantor trust status ceases during the owner's lifetime, gain is recognized. While the law is unclear on whether termination of grantor trust status at the grantor's death will cause gain recognition, there is a serious risk that it does. For these reasons, real estate subject to negative capital generally is not the ideal asset for most of the planning devices described above, such as the SLAT, GRAT, and IDIT sale.

On the other hand, the multi-class freeze partnership may present a planning opportunity for a negative capital account asset. Under the multi-class freeze partnership, the owner retains ownership of a significant portion of the entity owning the real estate in the form of the owner's preferred equity interest. If the interest remains in the owner's name at death, there will be a step up in basis under the basis rules of Section 1014, and negative capital will be erased to the extent of the deceased owner's interest in the partnership. If a transfer strategy such as the SLAT, GRAT, or IDIT sale is chosen instead of the multi-class freeze partnership, the applicable trust agreement should contain language permitting the grantor to reacquire the trust assets.

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19 An S corporation may be able to obtain some of the benefits of the multi-tier freeze partnership. The corporation and a trust for the owner's family could enter into a partnership agreement. The corporation would contribute its real estate in return for preferred units, and the trust would contribute assets in return for common units. See, however, the discussion below on the possible income and conveyance tax consequences of distributing the real estate out of the corporation.

20 Section 731(b).

21 See Sections 707(a)(2)(B), 704(c)(1)(B), and 737.

Using the reacquisition power, the grantor can purchase the negative basis asset from the trust. The buy-back does not generate taxable gain. The reacquisition locks post-transfer appreciation inside the trust and puts the negative basis asset back in the grantor's estate where, upon the grantor's death, the basis step-up rules will wipe out the negative capital associated with the interest. The problem of negative capital is not present if the estate plan involves a transfer of shares in a C corporation owning real estate.

Conveyance taxes

Given the complexity of planning for real estate owners, it can be easy to overlook the application of state and local conveyance taxes to a particular plan. While a survey of the real estate conveyance tax laws of the 50 states is beyond the scope of this article, the rules of the authors' home state illustrate how these taxes can apply. Under Connecticut's rules, a transfer of an interest in real estate for consideration will generate a state conveyance tax of between .75% to 1.25% and a municipal conveyance tax of .25% or .50%, with the applicable rate depending on the value and location of the property.[22] However, a transfer for no consideration will not. This can mean, for example, that a gift of real estate to a SLAT or a GRAT will not generate a conveyance tax, but a sale to an IDIT will generate a tax.

Connecticut's conveyance tax applies only to transfers of real estate and not to transfers of interests in entities that own real estate. Therefore, use of a C corporation, S corporation, limited partnership, or LLC may be a means of avoiding conveyance tax in certain circumstances. Connecticut does, however, impose a "controlling interest transfer tax" (CITT). The CITT applies to a transfer of a greater-than-50% interest in an entity owning real estate.[23] Transfers that are a part of one transaction, or a series of related transactions, generally are aggregated for purposes of the 50% test.[24] Consequently, it is generally not possible for an owner to transfer a 49% interest in an entity to two separate trusts and avoid the tax. The CITT applies to transfers for consideration.[25]

Several states have conveyance and CITT tax systems similar to those of Connecticut. The prudent planner will, therefore, consider the potential application of these taxes early in the planning process.

Death of the owner

The owner's interest in a real estate entity receives a step up in basis equal to the fair market value of the interest as of the date of death under the rules of Section 1014. The step up, however, applies only to the owner's interest in the entity itself, or the "outside basis." There is not a step up in basis of the real estate or other assets owned by the entity ("inside basis"). As a result, a post-death sale of appreciated entity assets may generate a capital gain notwithstanding the automatic step up in basis rules.

Section 754 election. It is possible to avoid this result for real estate owned in a partnership or LLC. Section 754 permits a partnership or LLC to make an election to adjust inside basis to fair market value. But the planner needs to keep in mind that there are instances where the Section 754 election will not be made.

First, the election must be made on the entity tax return. If the decedent's estate does not control the filing of that return, the entity may simply refuse to make the election because of the increased record-keeping required.

The election will cause an inside basis adjustment to fair market value whether the adjustment increases or decreases that basis.

Second, a 754 election is not always beneficial. The election will cause an inside basis adjustment to fair market value whether the adjustment increases or decreases that basis.[26] Accordingly, an analysis should be undertaken in each case to determine if a 754 election will be beneficial. The 754 election is often not made when discounts are applied in valuing a decedent's outside basis to fair market value for estate tax purposes, as the discounts will reduce the decedent's inside basis below cost basis. Also, if the adjusted basis of all entity property exceeds the fair market value of such property by more than $250,000 on the date of death, the decedent's inside basis must be stepped down to decedent's outside basis regardless of whether a 754 election is made.[27]

S corporation liquidation. A 754 election is not available for a decedent's shares in an S corporation. In some cases, however, it may be possible to achieve a step up of inside basis by liquidating the S corporation in the year of the deceased shareholder's death. A corporate

22 Connecticut General Statutes, § 12-494.

23 Connecticut General Statutes, § 12-638b(a)(1).

24 Connecticut General Statutes, § 12-638b(a)(2).

25 Connecticut General Statutes, § 12-368n; see also Connecticut Department of Revenue Services Special Notice 2003(11).

26 Reg. 1.754-1(a).

27 Sections 743(a) and (d).

28 See Section 336.

liquidation is considered a deemed sale of the corporation's assets, resulting in capital gain or loss.[28] Because the gain at the corporate level is passed out to the deceased shareholder's estate, there may be an opportunity to obtain a step up of outside and inside basis of the shares to fair market value as of the owner's date of death.

For example, suppose a decedent was the sole shareholder in ABC, Inc. The sole asset of ABC, Inc. is real estate with a basis of $100,000. At the owner's death, his outside basis is stepped up to fair market value, say $500,000. Inside basis remains at $100,000. Assuming the fair market value of the real estate is $500,000, a corporate liquidation will result in a capital gain of $400,000, which adjusts the basis of the real estate to $500,000. The deemed gain on the corporate liquidation passes through to the estate, increasing the basis of the stock to $900,000.

The liquidating distribution of the corporate assets (the real estate) to the estate is considered payment in exchange for the estate's shares.[29] Consequently, the estate will recognize a capital loss offsetting the gain from the liquidation. That is, the estate receives an asset having a value of $500,000 in exchange for its stock having a basis of $900,000, generating a loss of $400,000. This loss is netted against the deemed gain of $400,000, thereby producing a net of zero.

Whether the liquidation technique will make sense in a given estate depends on a variety of factors, including whether there are surviving shareholders, whose outside stock basis would not be stepped up upon the death of the decedent shareholder, and who may have no interest in distributing the real estate or in liquidating the corporation.

Eligible S corporation shareholders. Unfortunately, the authors have seen circumstances where the death of an S corporation shareholder resulted in the termination of the S corporation election. As discussed above, only specific types of trusts qualify as S corporation shareholders. Planners sometimes fail to realize this—with the unintended consequence being that S corporation shares pass to a trust that is not a qualified shareholder, thereby terminating the corporation's S status. A decedent's estate is a qualified S corporation shareholder. Any trust that receives shares from the estate has a two-year grace period in which to qualify as an S corporation shareholder. This two-year grace period runs while the estate holds the stock and if the trust does not qualify at the end of the period, the S election for the corporation will terminate.[30]

These rules make it critical to determine during the grace period whether the trust to which the estate shares are distributable will qualify as an S corporation shareholder. If the trust does not constitute a QSST, perhaps an ESBT election is viable, or outright distributions of the shares can be made to avoid termination of S corporation status.

C corporation consequences. C corporation shares owned by a decedent shareholder also obtain a step up in outside basis to fair market value as of the date of death. However, as with an S corporation, no Section 754 election is available to a C corporation to provide an inside basis step up. Because C corporations are subject to the corporate-level tax, the S corporation liquidation strategy described above will not provide an income tax benefit for a C corporation. Pursuant to Section 336, a C corporation must recognize gain on a liquidation as if the property had been sold.

Conclusion

Over the years, the authors have learned to think about planning for owners of commercial real estate as a complex enterprise, whether the work relates to the planning process or an estate administration. Inevitably, one or more of the unique challenges posed by the real estate interest will become a primary consideration that must be addressed. Obviously, our preference would be to be involved while the owner is considering his or her entity selection, but that decision has often been made well before we meet the client. Occasionally, our initial engagement is during an estate administration, or after an audit letter has been issued.

Each situation raises questions and issues regarding the benefits and limitations of the various entities used to hold real estate. Effectively managing these challenges and obtaining the best results possible for our clients depends on a comprehensive working knowledge of the various entities used to hold real estate. ■

[29] Section 331.
[30] Reg. 1.1361-1(j)(7(ii).