Challenges in Estate Planning with Investment Real Estate

By Mary P. O'Reilly and Andrew L. Baron

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Estate planning for clients in the investment real estate business is fraught with potential landmines that require careful consideration to ensure an effective plan. A key consideration for any estate plan is maintaining family harmony. This is particularly difficult for families in the investment real estate business, where the goal is often for all children—both those who are in and those who are outside of the business—to retain a stake in this income-producing asset. The tax aspects and illiquid nature of investment real estate also present unique challenges. In addition to the estate tax, which is typically the main focus in estate planning, income taxes must also be a key consideration because many real estate clients have so-called negative basis due to depreciation, refinancings, and past income tax deferral under Section 1031 of the Internal Revenue Code (the Code). Access to financial leverage also plays a critical role in estate planning for investment real estate families. Consideration must be given to ensure transfers do not violate existing loan covenants and take into account future access to financing. This article will explore each of these areas and provide suggestions on how to effectively navigate around these issues to build the most comprehensive and effective plan.

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Family Harmony

Minimizing family disputes is essential to all estate planning. When a family business is involved, counsel must take special care to prevent it from causing rifts among family members. Parents often serve as the glue holding siblings together and preventing rivalries from spiraling out of control. After the parents are no longer alive, their absence may result in hidden

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tensions and conflicts among children coming to the surface. This is especially true for investment real estate families, where the business can serve as the catalyst for this strife.

One explanation for this is the opposing ways in which businesses and families reward stakeholders. In businesses, compensation and advancement are traditionally merit-based and generally determined by the hard work and skill of an employee. In contrast, in families, parents typically divide their assets equally among children or, if anything, give more to the child who is less capable to ensure all children will be cared for and provided for. These diametrically opposed approaches make it difficult to determine the most equitable means to pass down the business.

This is further exacerbated when some children have dedicated their lives to the business and others have followed different pursuits. It is often easier for clients in non–real estate businesses to address this issue because siblings who are outside of the business do not always remain business partners with the sibling who is working in the business. When the family business is investment real estate, however, clients almost always want all their children—whether involved in the business or not—to inherit interests in investment real estate that can provide them with a steady income stream. This means that children who had been outside the business may be forced into a business partnership after their parents are gone, which is a great potential source of conflict.

Fueling this friction are the different perspectives of the children. For example, from the perspective of a hypothetical son working in the business, he has sacrificed his own personal future—of doing something solely for his own financial gain—to help his parents and grow the family's wealth. Perhaps his own hard work and skill helped take the real estate to a new level of success that he attributes to himself. In contrast, from the perspective of the hypothetical daughter outside of the business, her brother was handed a job opportunity by mom and dad, who took him under their wings and trained him, while she had to work on her own to make her own career and future for herself. Both of these perspectives may be correct, and often they are not even voiced while mom and dad are alive. As previously mentioned, these issues typically arise after the parents have passed on because they are no longer there to play their role of keeping sibling relationships and rivalries in check. The influence of the children's spouses often exacerbate these feelings.

The key to minimizing or preventing this sibling conflict is for the parents to address this explicitly in their planning. Children spend their entire lives having parents decide how things will be, so estate planning is not the time for parents to leave it up to the children to figure it out for themselves. To maximize the chances of success, the plan should reward and incentivize the child who is in the business to continue to grow the business. It also should give the children outside of the business the opportunity to be bought out over time or the option of not participating in future deals or properties if they do not wish to have their finances under the thumb of their sibling. Often, arm's-length business arrangements can be replicated with family-owned real estate. The key to determining which plan will work best for a family is understanding the type of investment real estate business the client is in and the different roles the family members and other third parties play. Regardless of the plan chosen, however, to ensure the greatest likelihood of success, it is worth repeating that this plan should be dictated by the parents in their planning and not left up to the children to figure out after the fact.

Tailored Succession Strategies

Unlike many other family businesses, one advantage of the investment real estate business for families that own multiple properties is that each property can typically stand on its own and have value apart from the other properties. This ability to divide the portfolio by property among the children is an advantage to owning a real estate business and is a simple and straightforward succession strategy, where each child or a trust for the child receives a separate building or an interest in a separate building. One benefit of this approach is that the children are not tied to each other financially, minimizing the business as a source of friction among them. From an income tax perspective, this should be done during the client's life or during the estate administration process. Once children receive interests in different buildings, it is much harder to swap assets from one child to another child without income tax repercussions. As detailed below, transfers of real estate during

life should be made to "grantor trusts." This is particularly helpful when giving each child a different property because it provides the ability to move property from one trust to another without income tax consequences.

One downside of the approach of dividing the portfolio among the children is that a property set aside for one child may outperform the properties set aside for the other children. Counsel can address this issue by providing an equalization mechanism in the will to compensate for any disparity in the values of the properties, including properties that have already been gifted and are outside of the taxable estate. Valuation and adjustment should be performed by a neutral third party to minimize potential conflicts among the siblings. Another downside to this approach is that the client may have reservations about the child who is outside of the business being able to manage that child's own property without the help of the child who is involved in the business. In those instances, the clients can still divide the portfolio and name the child involved in the business as the manager of the sibling's property, but should provide for financial incentives for that child's continued management of all the properties, while also giving the child who owns the property the ability to change property managers if it is not working out.

Nonetheless, for many clients, separating the real estate and leaving each child in control of that child's property is not a workable solution. For example, the client may not have confidence that the child outside of the business can successfully take on this responsibility of having ultimate control over the property manager. Also, the client may see investment real estate as an important asset to provide the child with a steady stream of income for life and may not want to leave it up to the child to liquidate and cash out of the business and shower the child with too much wealth. Although using trusts with an independent trustee can help mitigate against some of these concerns, this arrangement may not be fully satisfactory.

For many of these clients, appointing the child who is in the business, and who may share the same mindset about the long-term value and stability of investment real estate, to be in charge of the entire portfolio is essential to the planning. In these cases, special care and consideration must be given to help minimize potential conflicts among the children, and it is often helpful to separate management of the properties that are already owned and operated during the client's life (Legacy Properties) from the management of new deals or properties that the child in the business may identify in the future to acquire and develop (Future Properties). In developing this planning, the way third-party property managers are compensated can be replicated here.

For example, there are typically three different roles that need to be addressed when managing Legacy Properties. The first is the property manager, whose role involves dealing with the tenants, collecting rents, coordinating repairs, and running the day-to-day property operations. In the marketplace, property managers typically receive a percentage of rent, so compensation for a child performing these duties can be based on what third parties charge for this work in that market. The second role is the leasing broker, who is responsible for renewing leases or bringing in new tenants. Again, this is a role where a third party can be hired or their rates can be duplicated for the child performing this duty. The third role is the asset manager. The asset manager oversees the entire property, including hiring and overseeing a third-party property manager and the leasing agent, if such roles were outsourced. The compensation for the asset manager can also be replicated by looking to what third parties in investment real estate joint ventures are paid, which may include a percentage of a property's revenue.

When the family real estate business is not just about maintaining Legacy Properties but also about acquiring and developing new properties, these future investments also must be carefully considered in a client's succession planning. There is often tension between the child in the business, who may seek to reinvest profits back into the business to develop or acquire additional properties, and the child out of the business, who wishes to receive those profits so that such child can be in control of a portion of that child's inheritance and no longer under the sibling's management. As such, clients should consider whether the child involved in the business has the authority to invest proceeds from Legacy Properties into new deals or whether the children outside of the business should have any say over this. A common way to address this tension is to provide that certain major decisions of the business, such as refinancings that pull equity out, improvements on an existing property over a certain amount, or the purchase of a new property, require the consent of a majority, a supermajority, or all of the children.

Again, to incentivize the child involved in the business to go into future deals, the compensation structure used in third-party joint ventures can be replicated. Typically, for new development, an operating partner is managing the development of the property and receives compensation in the form of a carried interest or promote (which has favorable capital gain treatment) and may receive other fees such as development management fees (based on the cost of construction) if it is also acting as the development manager. Additionally, the operating partner typically has some of the operating partner's own capital invested in the deal (i.e., skin in the game), so the partner also gets a return on the equity interest like the other investors. In the family real estate business context, if new deals are being financed from Legacy Properties, each child can invest equity into the new deal (or can have the option not to participate) and the child involved in the business would serve as the operating partner and be compensated with a promote and whatever other fees are appropriate. In third-party joint ventures, the fees and promote vary in structure and amount depending on the type of property and the particular market; that

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market practice could be mirrored in a joint venture arrangement among family members.

Buy-Out Provisions

Regardless of the real estate portfolio and the succession planning, providing the children (or cousins, in the next generation) with some ability to part ways is an important consideration that can be done by including a buy-out provision in the business operating agreement. There are various different buy-out provisions that can be used, and each one can be customized. Below is a brief description of some of the most common types, which can be tailored to strike the balance the client wishes to achieve between incentivizing children to not sell their ownership stake (by not making liquidation too easy) and by not forcing siblings to be in business together if it is damaging their relationship (by not making a sale too difficult).

Right of First Refusal. If a child wants to sell to a third-party willing buyer, a right of first refusal is triggered and other family members have the option to buy at that price or sometimes even at a discount. If not, the child can sell to the original third-party buyer for the price that was offered by that buyer.

Buy-Sell Appraised Value. If a child does not want to continue with the joint venture, the child can trigger a buy-sell mechanism, where the child agrees to either buy the interests of the other children or sell his interest to the other children (as elected by the other children) based on a purchase price determined by one or more appraisers (the agreement can designate the appraiser or name a neutral party to select the appraiser, or the children can pick their own appraisers). Sometimes, family buyers can purchase the interests over a term of years. The terms (money down, payment term, interest rate, collateral, default, etc.) can be predetermined and set forth in the agreement.

Shotgun/Revolver Buy-Sell. Enumerated major decisions can require majority or unanimous consent, and in the event of a dispute on a major decision, any child can make an offer to either buy the other child's interest or sell his interest, in either case at a price set by the offering child. The offering child sets the price and terms. The non-offering child then has the option to either accept the offer to sell (in which case that non-offering child becomes the seller) or buy (in which case the non-offering child becomes the buyer) on the same terms presented by the offering child.

Revolver with Sell Option. This option is similar to the above, but it prevents one side from taking advantage of the other side's illiquidity. The non-offering party, if it wants to buy but does not have the cash, has the option to instead require that the joint venture market the property for sale on those same terms. If the venture finds an outside buyer, a right of first refusal would then be triggered, where the offering child could purchase it.

Auction Buy-Sell. Here the children get an appraised value (again, agreement can set forth how the appraiser is chosen), and this is the starting point for the auction. Terms of eventual acquisition (money down, interest rate, collateral, default, etc.) are predetermined before the auction begins. Then the children have a blind auction from there (one round or multiple rounds), with the highest bidder being obligated to buy out the other, and the other being obligated to sell.

Call or Put Option. Any child may have the right to cause the venture to call or redeem the interest of one or more of the other children or to "put" its interest to the venture, typically after some period of time or after the occurrence of certain other events. The call or put price would typically be based on the fair market value of the underlying property.

Estate and Gift Tax Considerations

Minimizing estate and gift taxes is a key consideration for all estate planning. The federal estate and gift tax is imposed at a rate of 40 percent on all assets gifted during life or bequeathed at death that are in excess of the lifetime gift and estate tax exemption (Lifetime Exemption). Note there is no gift or estate tax on assets given to a qualified charity or to a US citizen spouse. The current Lifetime Exemption is $13,610,000; however, this amount is scheduled to sunset effective January 1, 2026, to $5 million (subject to an inflation adjustment). In addition to the 40 percent federal estate tax, clients may also be subject to a state estate tax, which is imposed by 12 states plus the District of Columbia. Connecticut, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York,

Oregon, Rhode Island, Vermont, Washington, and the District of Columbia each have an estate tax. Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania also each have a state-level inheritance tax.

One of the most common strategies used to minimize the estate tax for investment real estate is to gift an indirect interest in investment real estate during life to an irrevocable trust for the benefit of the client's descendants. Gifting to a trust for the child instead of to the child directly is recommended for various reasons, including protecting the gift from creditors (i.e., the child's spouse in the event of a divorce) and from estate tax in the child's estate if a client has available generation skipping transfer (GST) tax exemption. Also, if a client's spouse is living, it is recommended to include the spouse as a potential beneficiary of the trust (such trusts are known as so-called spousal lifetime access trusts or SLATs) to maximize the flexibility with the planning so that the client can access gifted property through the spouse. These trusts should be set up as intentionally defective grantor trusts (further described below) to take advantage of the grantor trust rules. Here, the client gifts an interest in a closely-held company like a limited liability company or a limited partnership that owns the real estate (Real Estate LLC). As such, the property gifted is an interest in the Real Estate LLC, which is typically valued with lack of control and lack of marketability discounts. The effect is to reduce the amount of the Lifetime Exemption that is used to move the property out of the taxable estate. In other words, by gifting an interest in the Real Estate LLC, which owns the real estate, rather than gifting the real estate itself, clients are able to transfer more value while using less Lifetime Exemption.

Gifts made to these irrevocable trusts during life will reduce the Lifetime Exemption, meaning the client will have less Lifetime Exemption remaining at death, but the benefit is that the property and all its future appreciation during the client's life will not be subject to estate tax at the client's death.

For clients with assets in excess of the current Lifetime Exemption, it is recommended that they make gifts before 2026 to take advantage of the current increase in the Lifetime Exemption before it sunsets. (Lifetime gifting will also reduce the state-level estate tax for clients living in states where there is no state-level gift tax but there is a state-level estate tax, such as New York.)

Any appreciation of the property in excess of this passes to the trust without any transfer taxes. Often, the transaction is structured so that the grantor first contributes the property to a closely held company like a limited liability company or a limited partnership and the grantor sells a non-managing and non-marketable interest in this company to the trust. As such, the property sold is valued with minority and unmarketability discounts, which serves to further diminish the value of the property that is frozen in the grantor's estate.

Although utilizing the Lifetime Exemption to move interests in investment real estate out of the taxable estate to irrevocable trusts during life is recommended, for clients with large estates, gifting alone will be insufficient to fully protect the client's estate from the estate tax. In these cases, clients will need to engage in further lifetime planning to freeze the value of their real estate portfolio and, over time, move the investment real estate and its appreciation out of their taxable estate. This is known as an "estate freeze," and there are a few different ways to accomplish it.

One common estate freeze technique is known as "a sale to an intentionally defective grantor trust." It is designed to freeze the value of an interest in investment real estate in the client's estate at its current value and shift any appreciation in excess of the applicable interest rate to a trust for descendants without any gift or estate tax. In a typical plan, the client establishes an intentionally defective grantor trust (IDGT) for the benefit of family members, which means the trust is structured so that the client is treated as the owner of the trust for income tax purposes but not as the owner for estate tax purposes. (Code Sections 671–679 list the powers that will make a trust a grantor type trust and care must be used to only use those powers that do not also cause estate tax inclusion such as the power to lend to the grantor for inadequate security or the power of the grantor to substitute assets for equivalent value.) The client "sells" an interest in the Real Estate LLC to a creditworthy IDGT for its fair market value (which is typically valued using lack of control and lack of marketability discounts) in exchange for a promissory note bearing interest at the applicable federal rate. (Although there is no direct law that requires the trust that engages in a sale must be creditworthy, most practitioners advise that the trust have assets equal to at least 10 percent of the value of the assets being sold to the trust.) Because the client is treated as the owner of the trust for income tax purposes, the transaction is not an actual "sale" for income tax purposes, so no income tax gain is realized on the sale of the property to the trust. Likewise, the client does not recognize any income tax upon receipt of the annual interest payments on the promissory note from the trust, nor does the trust get an offsetting interest deduction.

The sale to the IDGT effectively freezes the value of the property on the date of the sale, with any appreciation of the property in excess of the promissory note interest rate passing to the trust without requiring any Lifetime Exemption and without any estate or gift tax. Additionally, because the client is responsible for paying the trust's income taxes, the assets in the trust are permitted to grow income-tax-free while the client further depletes the taxable estate while paying this income tax liability each year from the client's other assets. This effectively allows the client to make a tax-free gift to the trust each year equal to the trust's income tax liability.

Another common freeze strategy is a so-called zeroed-out grantor retained annuity trust (GRAT) (governed by Code Section 2702), to which the client contributes an interest in the Real

Estate LLC. This is similar to the IDGT, except that instead of the client receiving back a promissory note, the client receives back an annuity equal to the value of the real estate plus the rate of return at the Section 7520 rate that is applicable to GRATs. Similar to the sale to a grantor trust, a GRAT serves to freeze the value of the property in the client's estate at its current value with any appreciation over the rate of return passing free of estate and gift tax to a trust for the client's children with no use of the Lifetime Exemption. (Note that with a GRAT, a client cannot allocate the GST exemption, so trusts here should benefit only children and not grandchildren or more remote descendants. Further, clients should understand the mortality risk of the clawback associated with using GRATs that can result in estate inclusion if the client does not survive the annuity period.)

Income Tax Considerations

The benefit of these traditional estate planning techniques such as gifts, sales to IDGTs, and GRATs is that assets are removed from the taxable estate and escape estate tax on the client's death. One downside, however, is the assets that are not included in a client's taxable estate do not receive a step-up in income tax basis at the client's death under Code Section 1014, which effectively erases any built-in gain on appreciated assets. Instead, the recipient takes the asset with a "carryover" income tax basis, meaning the recipient holds the asset subject to the same built-in gains the client had. Typically, this trade-off is worth it, because saving a 40 percent estate tax is better than saving a 20–25 percent capital gains tax. When it comes to investment real estate, however, this calculus is not so straightforward and must be carefully considered. In some instances, the income tax savings of having investment real estate included in the taxable estate may be more than the estate tax that would otherwise be due on it. This is because the estate tax is on the net equity of the real estate (i.e., the value of the property less the debt), whereas the income tax is on the total gain realized, which includes nonrecourse debt like mortgage loans from financings and prior depreciation.

Most real estate investors hold properties long term, which results in a decreasing tax basis. Because the Code assumes investment real estate is a depreciating asset, taxpayers can depreciate its value over a term of years through depreciation deductions, providing them with a loss that offsets income earned from the property. This depreciation causes the tax basis in the property to decrease over time. Additionally, as properties increase in value, owners are able to refinance for larger loan amounts, effectively pulling equity out of the property with no immediate income tax gain. This debt increases the owner's liability in excess of basis in the property. As such, when the property is later sold, these past depreciations and financings, which reduced basis below the debt amount, will be realized upon the sale, and in many cases result in a tax liability greater than the sales proceeds received after the lender is repaid. This phenomenon is commonly referred to as "phantom income."

By way of illustration, assume a client owns a $10 million building subject to an $8 million mortgage with a $1 million tax basis due to depreciation. If the client sells the property for $10 million, the $9 million gain ($10 million sales price less the $1 million carryover basis) would be subject to a 25 percent section 1250 capital gains rate for depreciable real property, plus a 3.8 percent net investment income tax, for a total tax due of $2,592,000. The client will net only $2 million of sales proceeds once the $8 million mortgage is paid off, however, leaving the client with more tax due than proceeds received.

The same result would be achieved if the property were sold after the client gifted or sold the property to an irrevocable trust, because the trust takes the property with the same carryover basis as the client. In contrast, if the client died owning the property, the estate tax on the property would be 40 percent of the net value of $2 million, or $800,000, with no income tax due if the family sells it after death, because of the basis step-up, leaving the family without any phantom income and instead with $1.2 million of proceeds after the loan and estate taxes are paid. Additionally, the family would have a new $10 million basis, which could be depreciated against and used to offset future income earned from the property. But once again, this calculus is not so simple because it does not capture the potential estate tax savings that would be realized if the property continued to appreciate over the client's lifetime after it was gifted, which might be significant; nor does it reflect the reality that real estate investors will rarely sell and realize income tax gain and instead opt for Section 1031 exchanges so that they pay no income tax on the sale. Nevertheless, as illustrated above, the basis step-up at death may save real estate families more money in the long run and free future generations from the liquidity handcuffs of liabilities in excess of basis and endless Section 1031 exchanges, which have been under attack in recent White House budget proposals. *See* Press Release, The White House, Fact Sheet: The President's Budget Cuts Taxes for Working Families and Makes Big Corporations and the Wealthy Pay Their Fair Share (Mar. 11, 2024) (proposing to eliminate "like-kind" exchanges).

Even for clients who do not contemplate selling property except through a Section 1031 exchange, one uncertainty of transferring real estate with liabilities in excess of basis to an IDGT or GRAT is the potential of triggering a portion of the built-in gain upon the death of the client. This is because the income tax repercussions of such properties upon the termination of the grantor trust status because of the client's death are uncertain under current law.

Estate Tax Deferral

Another consideration that should not be overlooked in planning with investment real estate is qualifying for the estate tax deferral under Code Section 6166 because of real estate's illiquid nature. Simply put, if a client owns

(together with family) 20 percent or more of a closely-held business that makes up 35 percent or more of the client's adjusted gross estate, rather than having to pay the estate tax attributable to the business nine months from the date of the client's death, the client's estate can defer payment of the tax over time. The timing of the deferral and the interest rate on the deferred tax vary, with the maximum deferral being no payment of tax due for the first five years, followed by payment of the estate tax in equal payments over the next 10 years. Since the key to qualifying for this deferral is the client owning an interest in a closely held business, this should not be overlooked in doing estate planning for investment real estate. For a detailed discussion on how to qualify for Section 6166 estate tax deferral when planning with investment real estate, see Stephen M. Breitstone, Mary P. O'Reilly & Andrew L. Baron, *Common Pitfalls in Estate Planning with Investment Real Estate*, N.Y. Univ. 81st Inst. on Fed. Tax'n, ch. 16, § 16.03 (2023).

Freeze Partnership

A lesser-known estate-planning freeze technique known as a "freeze partnership" should be considered when planning for investment real estate clients. The freeze partnership moves appreciation of the real estate out of the taxable estate while avoiding the income tax pitfalls of the GRAT and the sale to the IDGT. By carefully following the provisions of Code Section 2701, the freeze partnership freezes assets at their current values in the client's taxable estate while shifting appreciation to the lower generations. Further, because the client retains an interest in the freeze partnership, the planning can be structured to take advantage of the estate tax deferral under Code Section 6166. *Id.*

In a freeze partnership (which is often done in the form of an LLC), the person doing the planning (Senior) transfers investment real estate into an entity created for this planning (Freeze LLC) in exchange for a preferred or "frozen" interest. The Freeze LLC also creates the junior interest, which is a common or "growth" interest entitled to the growth of the underlying asset in excess of the preferred rate of return (which is referred to as the hurdle rate). (The freeze partnership does not work well for low-yielding assets that do not generate sufficient income to pay the required hurdle rate to Senior. In those instances, a "reverse freeze," where Senior retains the common interest and transfers the preferred interest to an IDGT, should be considered. *See id.* § 16.02[1][e].) This rate is determined by an appraisal of a market return and is actually one downside to this technique over a GRAT and a sale to the IDGT because it is almost always a higher rate. (This higher hurdle rate, also known as the "leaky freeze problem," can be mitigated against by "leveraging up" or through a "capital

shift." *See id.* § 16.02[1][d].) Senior then transfers this junior interest to an IDGT for his or her descendants, while retaining the preferred or "frozen" interest in Senior's estate. Under income tax principles, the liabilities in excess of basis and the capital value of the property contributed by Senior are allocated to the preferred interest and are entitled to a basis step-up under Code Section 1014 at Senior's death, and the growth in excess of the hurdle rate allocated to the junior interest is outside of Senior's taxable estate in the IDGT. This eliminates the phantom income attributable to liabilities in excess of basis (in the case of outright real estate ownership) or negative capital accounts (for real estate owned by a partnership or limited liability company).

Joint Revocable Trust

Another alternative for planning with low basis real estate among spouses is for them to create a jointly established revocable trust (the joint revocable trust). (Note that for clients who live in community property states, all community property receives a step-up upon the death of the first spouse. The joint revocable trust replicates this concept for other property and for clients not living in community property states.) The benefit of the joint revocable trust is that assets held in the trust receive an income tax basis step-up upon the death of the first spouse. The downside of the joint revocable trust is that the strategy does not freeze estate values. Accordingly, without further planning after the death of the first spouse, the property contributed to the joint revocable trust will all be included in the surviving spouse's estate.

With this strategy, two spouses create and fund the joint revocable trust, with each spouse owning a separate share of the trust. Each spouse has the right to amend or revoke his or her portion of the trust (without the consent of the other) while both are living. The first spouse to die is granted a testamentary general power of appointment (i.e., the right to appoint principal among a class including such spouse, his or her creditors, his or her estate, or

the creditors of his or her estate) over the entire trust (including the other spouse's share). Because the order of death of the spouses cannot be known, each spouse executes a will exercising his or her power of appointment over the entire trust directing the property to be held in continuing trust for the surviving spouse (typically with a credit shelter trust or marital trust allocation). Because the first spouse to die has a general power of appointment over all assets in the joint revocable trust, the entire trust is includable in his or her estate pursuant to Code Section 2041 and should qualify as property acquired from a decedent under Code Section 1014, resulting in a step-up in basis for all the assets in the trust.

Section 1014(a)(1) of the Code states, "[e]xcept as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall ... be the fair market value of the property as of the decedent's death." Code Section 1014(b)(4) further states that "Property Acquired from the Decedent" includes "[p]roperty passing without full an adequate consideration under a general power of appointment exercised by the decedent by will." Thus, on its face, the structure of the Joint Revocable Trust and exercise of the general power of appointment fall squarely within the basis step-up of Code Section 1014.

Keep in mind that Code Section 1014(e) precludes a basis step-up if there is property acquired by the decedent within one year of death and such property is then transferred to the original donor of such property upon the decedent's passing. It has been the IRS's position in Private Letter Rulings and also in a Technical Advice Memorandum that although joint revocable trusts may be used to pull assets into the estate of the first-to-die spouse and be available to fund credit shelter or marital trusts, a basis step-up is not permitted because of the application of Code Section 1014(e). *See* I.R.S. Tech. Adv. Mem. 9308002 (Nov. 16, 1992); I.R.S. Priv. Ltr. Rul. 200101021 (Jan. 5, 2001); I.R.S. Priv. Ltr. Rul. 200210051 (Mar. 8, 2002). But these IRS rulings have drawn wide criticism from many commentators for their faulty logic and lack of analysis. *See* Howard M. Zaritsky, *Running with the Bulls: Estate Planning Solutions to the "Problem" of Highly Appreciated Stock*, 31-14 Univ. of Miami L. Ctr. on Est. Plan. § 1404; Richard A. Williams, *Stepped-Up Basis in Joint Revocable Trusts*, 133 Trusts & Estates, no. 6, June 1994, at 66; *see also* Frederic A. Nicholson, *Ruling on the Joint Spousal Trust Ignores Statutory Intent*, 59 Tax Notes 121 (Apr. 5, 1993). The IRS argues that the joint trust structure creates a gift from one spouse to the other upon death that is then immediately reacquired by the surviving spouse. But the grant of a general power of appointment is generally not considered a gift of the property over which it may be exercised. Also, directing that the property pass to the trust for the surviving spouse's benefit, rather than outright to the spouse, should seemingly satisfy the plain language of Code Section 1014(e). The IRS also argues that the property does not pass from the deceased spouse to the surviving spouse as required under Code Section 1014(a) because

the surviving spouse never relinquished control; however, this fails to consider the plain language of Code Section 1014(b)(9), which states that property acquired through power of appointment satisfies this Section 1014(a) requirement.

Lending Implications

When estate planning with encumbered real estate (whether the property is owned directly in the client's name or in an entity in which the client owns an interest), care must be taken to ensure transfers do not run afoul of transfer restrictions contained in the loan documents. Even when transfers for estate planning purposes—such as transfers to family members, trusts for their benefit, or other affiliated entities—are expressly permitted, they may require that notice be given to the lender before making such transfer or that other conditions be satisfied. Each lender and each deal are different. As such, before making any transfers, the relevant loan documents should be reviewed. Depending on the terms of the loan documents, the consequence of failing to follow the applicable notice or consent provisions could trigger a default or due-on-sale clause that accelerates the loan, or, worse, it could trigger recourse liability to the borrower or to a guarantor without anyone realizing it. *See Current Issues in Like-Kind Exchanges*, SN023 ALI-ABA 879 (2007) ("A lender restriction might require that the loan becomes recourse to non-transferring [members] ... in situations in which the transfer is not approved by the lender.").

It is important for clients to understand that dealing with the lenders will take time and constitute a cost of the planning unless they handle it themselves. This is true even when mere notice to the lender (rather than their consent) is all that is required. Many lenders will request so called "know-your-client" (KYC) inquiries and ask for updated organizational charts, formation documents of newly formed entities, and copies of the transfer documents. They may even ask for a legal opinion for due authority and valid existence of the new structure. Lenders also may be permitted to charge fees under the loan documents for time spent reviewing the transfers.

Often, planning is done at the last minute, and it may not be possible to give notice or obtain lender consent in the short time frame allowed. Although not ideal, there are a handful of workarounds that may be considered in this scenario. One potential solution is to make the transfer subject to a condition subsequent that provides that if the lender does not subsequently give consent, the transfer of the property relating to that borrower is retroactively null and void. The benefit of this is that the transfer should relate back to the initial transfer date, but the downside is that it runs the risk of being considered an unpermitted transfer under the loan documents even if voided. Another solution is to transfer the interest subject to a condition precedent in the transfer documents, meaning the transfer is made upon the approval of the lender or upon expiration of the applicable notice period. This avoids the risk of an unpermitted transfer, but the downside is that the effective date of the transfer is upon expiration of the notice period or lender approval, as applicable.

Another consideration when planning with investment real estate is making sure the restructuring does not affect any net worth and liquidity requirements set forth in any guarantees to which any applicable family members or trusts have delivered, such as nonrecourse carveout guarantees that any family members or trusts may have delivered in connection with property financings. Some of these guarantees might also limit the ability of the guarantor to transfer assets if it would result in the net worth or liquidity requirements being breached.

A further aspect of the client's business that must be considered when doing planning is the interplay of the finances between their various properties. Often real estate investors use the income from certain properties to help grow or develop other properties and improve their overall portfolio. Whether by using liquidity from one property to improve or purchase another property, cross-collateralizing loans, or having one entity guarantee the loan of another entity, there may be significant interplay between the client's various properties that must be considered in the estate planning. Understanding these relationships between the properties should not be overlooked when determining which properties to plan with. Also, knowing these details allows steps to be taken to prevent the operations of the real estate business from causing estate inclusion under Code Sections 2036 and 2038. For example, if a property that has been transferred outside of the estate is being used to guarantee loans of entities still owned by the client, a guarantee fee agreement can be implemented to keep the transaction at arm's length and not leave it vulnerable to IRS attack. Additionally, when cashflow of one entity is used to improve a property owned by a different entity with no common ownership, this should be booked as a loan between the entities and should be tracked and paid.

As detailed above, there are many challenges in estate planning for the real estate investor. Paramount is making sure the business succession planning is structured to minimize potential fighting among children. Minimizing the estate and gift tax is also a key focus, but income tax planning and estate tax deferral also must be considered, particularly when a client's real estate has liabilities in excess of basis. Finally, loan documents must be reviewed and the finances of the properties must be considered to make sure the planning does not have any negative financial consequences for the client. ■