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Steve Leimberg's Estate Planning Email Newsletter Archive Message #2821

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Subject: David Pratt & Jeff Baskies - The Time Has Come to Implement Painless Giving: How to Gift One or More Residences Prior to the End of the Year Without "Feeling It"

"With only a few months left before the Election and a possible reduction in the $11.58 million federal gift, estate and GST tax exemptions in 2021, the time has come for clients to get serious about using their exemptions. It is no secret that many clients are reluctant to gift income producing property that will make them 'feel' less wealthy. For these types of clients, making gifts of interests in one or more residences (whether fee simple interests, fractional interests or interests in entities owning a residence) may be most appealing.

Another attraction to gifting a residence is that when a residence is divided into two or more parts and a gift of a 'fractional interest' in the residence is made, the fractional interest should be discounted. Indeed, there is an abundance of case law supporting discounts for fractional interest in real property. And while such discounts could be legislatively repealed in a Joe Biden Administration, especially if the Congress also swings to the left, they are alive and kicking for the time being and should be used when possible. In addition, if a residence is owned by an entity, such as a limited liability company or limited partnership, minority interest and lack of marketability discounts should apply to reduce the value of the gifted interest in such entity for transfer tax purposes.

For all of these reasons, and for other good reasons, gifts of a residence, particularly partial interests and gifts of entity interests in an entity that owns a residence, will be an important technique for use of the current $11.58 million gift tax exemption before the end of this year. And, because a residence is not income producing, this type of gift may be most appealing for many clients.

Recently, in Asset Protection Planning Newsletter #409, Jeff Baskies alerted LISI readers of the various traps that can arise when planning with a Florida homestead. And a few years ago in Estate Planning Newsletter

#2445, David Pratt discussed the Proposed Regulations issued in 2016 that would have effectively eliminated most discount planning. Fortunately for clients and tax practitioners, in response to then new President Trump's mandate to reduce tax regulatory burdens, the Treasury Department withdrew such regulations. Thus, until reintroduced in a different version, discount planning continues to work.

David and Jeff recognize that many clients will avail themselves of the unique planning opportunities residences afford to use their exemptions before year-end. Therefore, these two Boca Raton planners joined forces to share a summary of suggestions for using one or more residences (or partial interests in such residences) as a 'painless giving' component of gift planning to exhaust a client's gift and GST tax exemptions in 2020."

David Pratt and **Jeff Baskies** provide members with commentary that shares a summary of suggestions for using one or more residences (or partial interests in such residences) as a 'painless giving' component of gift planning to exhaust a client's gift and GST tax exemptions in 2020. The authors wish to thank and acknowledge the following appraisal firms, representatives of which responded to their survey: (i) Business Valuation Analysts, LLC, (ii) Pluris Valuation Advisors LLC, (iii) Sheldrick, McGehee & Kohler LLC, (iv) Stout Risius Ross, LLC and (v) Valuation Services, Inc.

David Pratt is the Chair of the Private Client Services Department of **Proskauer Rose LLP** and the Managing Partner of Proskauer's Boca Raton office. Mr. Pratt is a Fellow of the American College of Trust and Estate Counsel (former Regent and current member of the Estate and Gift, Asset Protection, and Legal Education Committees) and American College of Tax Counsel, is Florida Board Certified in Taxation, and Wills, Trusts and Estates, has served on the Florida Bar's Real Property, Probate and Trust Law Section's Wills, Trusts and Estates Certification Committee, and is a former chair of the Tax Section of the Florida Bar. He is also an adjunct professor at the University of Florida's Levin College of Law and the University of Miami Law School, where he teaches in their LL.M. programs.

Jeffrey A. Baskies, is a Florida Bar certified specialist in Wills, Trusts, and Estates law. He practices at **Katz Baskies & Wolf PLLC**, in Boca Raton, FL, a boutique trusts & estates, tax & business law firm. Jeff is a frequent LISI contributor. In addition to over ten dozen published articles, he is the

successor author of the treatise: Estate, Gift, Trust, and Fiduciary Tax Returns: Planning and Preparation (West/Thomson Reuters 2013-2016). He can be reached at www.katzbaskies.com.

Here is their commentary:

EXECUTIVE SUMMARY:

Clients seeking to lock in their $11.58 million federal gift, estate and GST tax exemptions before the end of the year will undoubtedly be interested in funding the gifts with one or more residences. For many clients, interests in real property, and particularly interests in residences - whether fee simple interests, fractional interests or interests in entities owning residences - are an ideal asset for planning.

The current $11.58 million per person transfer tax exemption is scheduled to sunset on December 31, 2025 (reverting to $5 million, indexed for inflation, per person); however, there is a great deal of concern the exemptions may be greatly reduced in any tax legislation passed in 2021 under a Biden administration (perhaps even lower than $5 million per person).

Brad Dillon highlighted how easy it might be to reduce the exemptions by a simple majority vote, in Estate Planning Newsletter #2804, entitled: “Yes, Democrats Could Enact Retroactive Tax Legislation Next Year with a Simple Majority Vote, So Plan Now or Forever Lose Your Exemptions!” Subsequently **Alan Gassman**, **Jerry Hesch** and **Marty Shenkman** reinforced the importance of immediately implementing irrevocable trust plans in Estate Planning Newsletter #2813, entitled: “Irrevocable Trusts for Promissory Notes Before Year-End and Forgive the Notes If Joe Biden Is Elected, A/K/A What You May Not Know About Valuing Promissory Notes and Using Lifetime Q-Tip Trusts.”

Given the chance the exemptions go down next year, gifting to trusts for spouses and children will assuredly be at the top of the minds of clients and practitioners through the end of 2020. Indeed, there is already a great deal of irrevocable trust planning in process with the goal of funding before year end. Some clients are gifting to trusts (frequently taxed as “grantor trusts” for income tax purposes) for their children and descendants, and many married clients are planning with SLATs (spousal lifetime access trusts), to reduce the psychological hurdles of “giving away” and feeling less wealthy.

Whether using lifetime gift trusts for descendants or SLATs, many clients will be attracted to the concept of gifting non-income-producing real property assets (like primary homes and vacation homes) because such gifts do not impact their sense of economic comfort. There are many clients looking for the simplest and most painless solutions. Such clients will prefer to keep the assets that produce the income they live on, and gift assets that do not produce income, such as primary or vacation homes. Clients often say they feel less pain gifting away such non-income-producing real property.

Furthermore, some clients will be enticed to fund irrevocable trusts using fractional interests in residences or partial interests in LLCs or FLPs that own residences seeking the benefits of valuation discounting, before such benefits also disappear in a future round of tax reform. Valuation discounts have historically been accepted by the Tax Court when determining the fair market value of fractional interests in real property. The discounts are most commonly provided for the lack of marketability and liquidity, the costs of a partition action, and the lack of control.

We recall in the waning years of the Obama administration how the Treasury proposed regulations under Chapter 14 to essentially void discounting in connection with intrafamily transfers. It is possible that a Joe Biden Administration could revive those proposed Treasury Regulations or could legislatively repeal the case law supporting valuation discounts, even more so if the Democrats control Congress. Therefore, clients should consider taking advantage of valuation discounts when executing on planning techniques in late 2020.

COMMENT:

Because so many clients desire to use the transfer tax exemptions before the end of 2020, there is great pressure likely building to fund irrevocable trusts with real property. We will all be seeking ways to fund SLATs and gifting trusts with interests in all sorts of real property, including fractional interest and interests in LLCs or FLPs owning real property.

For unmarried clients or those wealthy enough to prefer funding trusts for children and descendants, there may be economies to a single trust; however, there may also be valid reasons to consider multiple trusts (perhaps one per child bloodline, or per stirpes).

Without delving into a full discussion of the costs and benefits of “one pot trusts” vs “separate share trusts” for planning purposes, the authors suggest that for transfers of interests in residential real property and/or entities owning residences, creating multiple, separate trusts offers another benefit in terms of valuation discount planning. Obviously, if a client with two children transfers a 100% fee simple interest in a residence she owns to a single trust for her descendants, the transfer should not be eligible for any discounting. If the same client with two children creates separate irrevocable gift trusts for each child (and probably each child’s descendants), and then she transfers 50% of the residence to each of the trusts, the transfers should both be entitled to valuation discounting.

Conversely, some clients will prefer creating SLATs to utilize their transfer tax exemptions. To obtain valuation discounts, such clients may transfer less than 100% and retain a fraction of the property. However, in SLAT planning, some clients may prefer not to retain any of the property at all, particularly if the residence is in an entity, where gifting the entire entity would reduce estate tax inclusion risks. A portion of those clients will prefer not to plan for discounts, as they are scrambling to find ways to use up the full transfer tax exemption, anyway. Another portion may seek to fund the SLAT with a fraction of the residence or the entity owning it and perhaps gift the balance to a secondary trust for descendants. Such planning might create valuation discounts, but of course the planning could become quite complex.

If clients’ are contemplating irrevocable gift trusts (i.e., for children and descendants) as opposed to SLATs, then as a further planning point, the trusts should likely be structured as “grantor trusts” so that future rent payments (assuming the clients will continue to use the property they gifted but will pay rent for the use of the property) won’t create taxable income. For these clients, it will be crucial to plan ahead, enter into written leases and, on an on-going basis, ensure compliance. This includes the clients paying “fair market value” rent, which should be determined by an independent real estate broker or appraiser.

Unless there is a proper lease arrangement in place and payment of fair market rent for the privilege, the IRS will use Section 2036 to argue for inclusion in the transferors’/clients’ estates under Section 2036. For clients creating SLATs, rent payments are probably not required, as their spouses as trust beneficiaries will have rights to use the property that is gifted to the SLATs.

Use of the gifted property by the grantors at the will and discretion of their spouses as beneficiaries should not cause inclusion under Section 2036. Depending on the structure, however, rent may be required upon the first death. Therefore, the careful drafter should ensure the SLAT and any subsequent subtrusts for descendants thereunder (after the spouse-beneficiary's death) are treated as "grantor trusts" for income tax purposes so that if rent is paid after the spouse-beneficiary's death, there should still be no income tax consequences. A full discussion of this issue is beyond the scope of this article.

Further, if the gift planning involves transferring an interest in a Florida homestead property, particularly one with a built-up "Save Our Homes" cap exemption benefits, then planners are encouraged to review LISI Message #409, Jeff's article entitled "Some "Dos" and "Don'ts" If You are Planning with your Clients' Florida Homesteads in 2020".

Summary of a Sampling of Case Law Regarding Discounts for Fractional Interests

The Tax Court has historically allowed for the use of valuation discounts when determining the fair market value of fractional interests in real property, but the inquiries are fact-specific and in some cases, discounts were not allowed. The authors will not attempt to provide a complete summary of the law of valuation discounts, and there are many resources available to provide readers with a more complete overview of the case law and IRS rulings on the subject; however, this article will address a few important concepts and note a few interesting cases.

While many appraisers applied discounts for lack of control and lack of marketability in the transfer of Tenant in Common ("TIC") interests, the IRS has argued such discounts should be limited to the costs of a partition action as each TIC owner has a right to partition the property. For example, the Service's position in Tech. Adv. Memo. 9336002 was that the discount available for a transfer of a TIC interest was limited to the costs of a partition action.

However, in perhaps the seminal case involving fractional interest discounts, *Samuel J. LeFrak v. Commissioner*, the Tax Court noted that the cost of partition is only one factor to consider.[i] Moreover, after considering the cost of partition and the uncertainty of such a proceeding, the Tax Court in *LeFrak* allowed a 20% minority interest discount and a 10% lack of marketability discount for gifts to the donor's children of less than 10%

interests to each child in a number of apartment and office buildings. The *LeFrak* case is an important taxpayer victory and citation for discounts of fractional interests.

In *Estate of Brocato v. Commissioner*, the Tax Court allowed a 20% valuation discount on a 50% interest in multi-family residential properties.[ii] The court noted the IRS appraiser's reliance on the cost to partition the properties, but noted that courts should also consider factors such as the lack of control and lack of marketability, and even blockage and forced-sale discount factors.

In *Estate of Forbes v. Commissioner*, the Tax Court allowed a 30% discount for fractional TIC interests taking into account minority interest discounts, lack of marketability discounts (limited buyers for undivided TIC interests) and even possible conflicts among the owners (all of whom were family members).[iii]

In *Ludwick v. Commissioner,* the Tax Court allowed a notably low valuation discount of 17.2% for 50% interests in a Hawaiian vacation residence that were contributed to Qualified Personal Residence Trusts.[iv] The Tax Court acknowledged the costs to partition were not the only reduction in value for TIC interests; however, in *Ludwick*, the Tax Court did weigh and consider the likelihood of a sale without a partition action and weighted potential outcomes, resulting in a discount of only about 17.2%.

Larger fractional interest discounts were supported by *Estate of Mitchell*, where the estate and the IRS stipulated to the following fractional discounts in a beachfront property and a ranch property:

> A 32% discount for the 5% gifted interest in the beachfront property, and a 19% discount for the 95% retained interest in the beachfront property held by the decedent at death.
>
> A 40% discount for the 5% gifted interest in the ranch property, and a 35% discount for the 95% retained interest in the ranch property held by the decedent at death.[v]

There are also a number of cases involving valuation discounts in commercial TIC interests and/or in timberland; however, those are beyond the scope and purpose of this article.

In summary, the Tax Court has allowed valuation discounts on fractional interests in real property ranging from 15% to 60% based on lack of

marketability, lack of control and the time and cost associated with partitioning the property. The court must make a factual determination of the discount allowed after considering the particular facts and circumstances in each case.

Informational Poll of Appraisers Regarding Discounts for Fractional Interests

For those considering the benefits of valuation discounts for fractional interests in real property (TIC transfers), the authors informally (and very unscientifically) polled some appraisers they know for their insights.

Specifically, the authors presented the appraisers with a hypothetical client who is seeking to transfer an undivided 50% TIC interest in residential real property. The authors reviewed the various responses received from the appraisers to provide some hopefully helpful guidelines for other practitioners to use in discussions with their clients.

Here are some of the lessons gleaned from the responses:

> The discounts varied, but the five appraisers' discounts all fell between 24% to 39%. Two appraisers suggested their firm discounts typically ranged from 24-30%; another estimated discounts in the mid to high 30% range; another advised typical discounts were in between, around 30-35%; while the last responding appraiser suggested typical discounts ranged from the high 20% range to the high 30% range.
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> A few of the appraisers noted that size of the percentage ownership may impact the discount level by a few percentage points. Generally speaking, the smaller the percentage ownership, the higher the discount and vice versa. While one specific appraiser felt the discount should not change based on the size of the TIC interest, and he said he did not agree with the logic that the discount should vary, he explained that his firm believed the IRS looks at various ownership percentages differently, so they do vary discounts a bit on their appraisals. Another appraiser stated that the valuation discount will vary within the range stated above depending on the rights and benefits associated with the interest being valued. For example, if the TIC interest is associated with a veto power to restrict a co-owner's right to sell at will, then that additional right and benefit

should be considered when deciding on a valuation discount percentage.

The authors asked the appraisers whether discounts for fractional interests apply similarly for residential and commercial properties, or if they apply a different analysis and discount level for commercial real property. Uniformly, the responding appraisers noted the analysis is similar, but there are additional factors they specifically apply when valuing commercial property (which are not applied in residential appraisals). One appraiser noted that some examples of unique factors of commercial property that impact valuation would include zoning restrictions or environmental issues. Two other appraisers suggested the discount for lack of marketability will likely be lower if the income produced by a commercial property is meaningful.

In light of the anticipated number of clients planning to take advantage of their gift and GST tax exemptions prior to the end of 2020, the authors also asked the appraisers about the cost and length of time needed to prepare an appraisal of a fractional interest in residential property. In this analysis, the authors directed the discount appraisers to assume the client would provide an appraisal for 100% of the property from a real estate appraiser, and the discount appraisers would rely on that valuation when performing a TIC or fractional interest discount analysis.

In response, one appraiser suggested that three to four weeks are typically needed to prepare a draft appraisal for review, but this timeframe can be shorter if needed and the appraiser can share the preliminary value of the interest prior to issuing the draft appraisal. Another appraiser suggested 4-6 weeks were needed for a full report, but said "numbers" could be provided sooner to facilitate planning, so long as the full report wasn't needed. Another appraiser suggested his firm was preparing about 5-10 TIC discount appraisals a month already and could turn new projects around very quickly if needed.

The various appraisers surveyed quoted fees to prepare discount appraisals that ranged from $3,000 to $10,000. One quoted a fee in the range of $4,000-5,000; another quoted a flat fee of $5,000 per TIC interest; the lowest estimate was $3,000-5,000 per TIC interest while the highest estimate was $8,000-10,000 per TIC interest.

One appraiser noted having a proprietary database to support the TIC analysis the firm applies. Another appraiser advised the TIC discounts his

firm applied had come down in the past decade, after the *Ludwick* case. His firm typically applied discounts of 24-30% post 2010, and he shared a redacted TIC appraisal indicating reliance on the following tax court cases:

Ludwick (2010) - 17.2%

Stevens (2000) – 25%

Brocato (1999) – 20%

Williams (1998) – 44%

Barge (1997) - 25%

Cervin (1994) – 20%

LeFrak (1993) – 30%

Van Loben Sels (1986) - 60%

As you can see most of the cases are pre-2010 and there are few recent cases to rely on.

Conclusion

As we careen toward the last few months of 2020, it is apparent gifting interests in real property will be a significant and important part of our practices. Hopefully, we will all be comfortable advising clients in such transfers and capable of conversing to our clients about the costs and benefits of valuation discounts in connection with such transfers.

Obviously, it will be hard to receive final appraisal reports prior to all the gifts clients will make at the end of the year, but in many cases the appraisals won't be needed until tax returns are filed in 2021 (in April - or more likely October for most clients). Yet it is helpful to have an idea of the typical range for TIC discounts (24%-39%) and the typical costs ($3,000-$10,000) and time needed to turn them around (most estimated 3-6 weeks, but they indicated numbers may be available ahead of a final report).

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

David Pratt

Jeff Baskies

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CITATIONS:

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[i] *Samuel J. LeFrak v. Commissioner*, T.C. Memo. 1993-520 (1993).

[ii] *Estate of Brocato v. Commissioner*, T.C. Memo. 1999-424 (1999).

[iii] *Estate of Forbes v. Commissioner*, 81 T.C. Memo. 1399 (2001).

[iv] *Ludwick v. Commissioner*, T.C. Memo. 2010-104 (2010).

[v] *Estate of Mitchell,* T.C. Memo. 2011-94 (2011).