Real estate strategies for gifting property

May 10, 2010 - Owners Developers & Managers

There are a few very important questions you need to ask yourself as a real estate investor. Have I accumulated a lot of assets? Do I have investment real estateâ€”or liquid assets? Would I like to start gifting some of my hard-earned assets to my children or grandchildren? Would I like to retain control over, or receive an income stream from the assets I transfer? Have I been told by my tax advisor that I may have estate tax "issues" that need to be addressed?

If you're like the majority of real estate investors, the answer to many or all of these questions should be in the affirmative. If this sounds like you, then the FLP or LLC might be another tool in your financial belt for 2010.

Both the FLP (family limited partnership) and the LLC (limited liability company) have been around for awhile, but they have recently gained greater momentum as the preferred vehicles for holding real property (and to a lesser extent, marketable securities). Why?

Two main reasons: 1) limitation of liability (hence, the name) and, 2) the ability to transfer the property gifted out of the owner's estate faster as the percentage of the property gifted actually increases with the application of discounts.

Here is a little more information to consider:

Limited Liability - Prior to the FLP/LLC, many individuals' real property investments were held personally (on schedule "E" of their tax return) or in a general partnership (filing form 1065). These two ownership methods afforded no coverage from personal liability from legal issues pertaining to the property. That is dangerous. The LLC, which is a hybrid entity, was introduced, and combined the limited liability of a corporation with the tax advantages of a sole proprietorship or partnership. You can even have a single member LLC, with no other partners. Even more advantageous, in an FLP, a limited partner's liability is limited to his/her capital invested.

Faster Transfer of Property - There are a number of reasons why you might want to begin transferring property to someone else (children, grandchildren, etc.). The most common reasons would be: 1) to minimize your taxable estate by removing assets that continue to increase in value, and 2) to get the recipient involved in the property (the extent to be determined by you).

In general, once an estate tax issue is brought to the surface, the sooner you act, the lower the value for gift tax purposes. This is where discounting comes into play. A revenue ruling has been issued by the IRS allowing minority (or lack of control) discounts when gifting minority interests to family members. However, to accomplish this, an "entity" of some sort must be established to hold the property. Technically, you will be gifting "shares" or a "percentage" of an interest in the created entity, not fractions of value of the underlying property. This is the distinction and the reasoning that allows the discounts. LLCs and FLPs (to an even greater extent as it pertains to discounting) are the best mechanisms around.

Here's how the gifting and discounting works:

Since the property is owned by your FLP/LLC, you would be gifting annual non-controlling, minority interests in that entity. The value transferred is not the prorated value of the commercial real estate itself, but the value of the specific interest in the entity owning the real estate. This non-controlling, minority

interest is worth much less than the proportional equivalent of the fair market value of the underlying asset. This is due to the lack of control associated with owning these interests, as well as the lack of liquidity in attempting to sell them at arms length (fair market value).

However, the discounts used must be backed up on an individual LLC or FLP basis in order to gain IRS approval. Simply attaching "average" or "standard" discounts based on empirical studies or court-allowed percentages generally will not fly. Study results and case law are indeed vital in arriving at a proper discount level, but it must be demonstrated in the valuation report how this data was interpolated to fit the FLP/LLC in question. Properly documented valuation reports should be attached to both gift and estate tax returns in these instances.

The FLP/LLC must have a true business purpose and the operating agreement should clearly spell this out, along with the control and transferability variables. The most important factor in determining the level of discount is the amount of control and liquidity that the gift recipient will have. Agreements that prohibit sales of interests to outside parties and that allow for distributions only at the discretion of the "Manager" (you, the real estate owner) generally require higher discounts. Work with a knowledgeable real estate attorney to get the agreement worded correctly for your particular goals.

All the FLP/LLC situations we've discussed have advantages and pitfalls. The key to achieving your goal is to work with advisors who are well-seasoned in using these entities to help you reach your desired results.

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