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This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. Because the enhanced federal estate tax exemption under the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act") has reduced the number of estates likely to pay estate tax, this issue focuses on estate planning with real property. Our goal is to share our insights with wealth and philanthropy advisors, corporate fiduciaries, accountants and other advisors in a way that is accessible and actionable. We welcome feedback and additions to our mailing list (*ipb@ipbtax.com*).

RECENT DEVELOPMENTS: INCOME TAXES AND REAL PROPERTY INTERESTS

By Doug Andre and Linda Kotis

Two recent developments interpreting existing law involving real property interests provide opportunities for tax planning. The first is the Internal Revenue Service's guidance on the manner in which a rental real estate enterprise qualifies for the section 199A deduction created by the 2017 Tax Cuts and Jobs Act. Taxpayers may use this "safe harbor" rule to structure their management of rental real estate to achieve eligibility for the deduction. The second is the U.S. Supreme Court's refusal to review cases imposing New York tax liability which led to double taxation of intangible income for individuals domiciled in Connecticut who also lived part-time and worked in New York. Taxpayers may wish to review their ownership of property outside of their state of domicile and determine whether it is possible to reduce their presence in a second jurisdiction so as to avoid classification as a statutory resident there for income tax purposes.

IRS Provides Clarity on Section 199A Safe Harbor for Rental Real Estate: In Rev. Proc. 2019-38, the IRS recently clarified the section 199A safe harbor for businesses that operate rental real estate. Under this guidance, a rental real estate enterprise will be treated as a single trade or business for purposes of the section 199A 20% passthrough deduction if it maintains separate books and records, the taxpayer performs 250 hours or more of "rental services" per year with respect to the enterprise, maintains contemporaneous records with respect to rental services, and complies with certain procedural rules. The revenue procedure makes clear that real estate rented under a triple net lease is not eligible for the safe harbor. We note an enterprise that fails to meet the safe harbor may still qualify under section 199A if the enterprise otherwise meets the definition of trade or business.

Supreme Court Declines to Consider State Tax Scheme as Commerce Clause Violation: Taxpayers in *Chamberlain v. New York State Dept. of Taxation and Finance*, and *Edelman v. New York State Dept. of Taxation and Finance*, were domiciled in Connecticut while working and maintaining residences in New York as well. The Chamberlains paid CT income tax on worldwide income, including the sale of their shareholder interest in a business entity. Because they lived more than 183 days in New York, they were also assessed NY tax on their intangible income (interest, dividends and capital gains) with no credit for the CT taxes paid. The Edelmans sold their NY-based shoe business and paid CT income taxes. NY income tax was due as well but the CT tax paid was not eligible for a NY tax credit because the income was not derived from economic activities in Connecticut as required under the NY statute. Each set of plaintiffs argued in their respective cases that New York is violating the dormant Commerce Clause, with the Edelmans stating that NY taxation inhibited their free movement into New York state and their ability to buy or lease a residence there. They asserted the NY tax scheme unfairly permits double taxation of intangible income attributed to New York statutory residents. The Appellate Division, Supreme Court of New York, affirmed the NY Supreme Court's rejection of plaintiffs' arguments in each case that the tax scheme unfairly burdens interstate commerce, and the Supreme Court denied certiorari.

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FOREIGN INVESTMENT IN U.S. REAL ESTATE

By Doug Andre

To avoid triggering adverse U.S. income and transfer taxes, non-U.S. individuals should undertake careful planning before investing in U.S. real estate.

Income Tax Considerations

Generally, an item of income is taxable to an individual who is neither a citizen nor a resident of the United States ("NCNR") only if it is "sourced" within the United States. U.S. source income includes rental income from leasing real property located in the United States and gains from the sale of U.S. real property.

Rental Income. To determine the tax consequences of U.S. rental income, an NCNR must determine whether the leasing activities rise to the level of a U.S. trade or business and if so, whether income is "effectively connected" with the U.S. trade or business. Effectively connected rental income will be subject to U.S. income tax and the NCNR will be required to file U.S. income tax returns.

Capital Gains. Although NCNRs generally are not subject to U.S. income tax on gains realized upon the disposition of appreciated property gains realized upon the disposition of a United States Real Property Interest ("USRPI") are automatically taxed as income effectively connected with a U.S. trade or business. The tax code requires the purchaser to collect the tax in the form of withholding. The definition of a USRPI includes direct investments in real property (including associated tangible personal property) and investments in U.S. corporations that own significant amounts of U.S. real property.

Estate tax considerations

The estate of an NCNR is subject to U.S. estate tax if the aggregate fair market value of the gross estate (*i.e.*, the decedent's "U.S. situs" assets) exceeds $60,000 in value. Estate taxes are calculated at rates ranging from 18% on taxable estates of $10,000 to 40% on taxable estates over $1,000,000. Real estate assets located in the United States are considered U.S. situs property, subject to U.S. estate tax.

A common method to avoid U.S. estate tax is to make inbound investments in real estate through a foreign corporation. Shares of a foreign corporation held by an NCNR at the time of death are generally not subject to U.S. estate tax. However, the foreign corporation may be subject to U.S. income taxes resulting in overall higher income taxes for the shareholders. In particular, the branch profits tax could apply if the foreign corporation is deemed to be engaged in business activities in the United States. Home country tax issues should also be considered.

Gift tax considerations

U.S. real property owned directly by a non-U.S. individual may be subject to U.S. gift tax if transferred as a gift. Gift tax does not apply to gifts by a non-U.S. person of intangible property (including stock in a U.S. or foreign corporation). Thus, if the individual contributed the real property to a corporation and subsequently made gifts of corporate stock, the gifts generally would not be subject to gift tax. We note that shares of stock in a U.S. corporation will be subject to estate tax if owned at death. The use of a corporation to hold real property may result in higher income taxes and greater U.S. tax compliance burdens.

Foreign investors should undertake a full analysis of these and other planning strategies (including whether a tax treaty applies) before investing in U.S. real estate.

ESTATE PLANNING ISSUES SPECIFIC TO REAL PROPERTY

By Ken Jefferson

It is common practice to advise clients to transfer their assets, including real property, into trusts, whether revocable or irrevocable. This is done for a number of reasons, *e.g.*, to avoid probate and streamline the administration of the client's estate, to reduce a client's gross estate and minimize or avoid federal and state estate taxes, or simply to provide creditor protection.

In dealing with transferring real property into trusts, however, estate planners should always be careful not to jeopardize any beneficial tax status associated with the property. Missteps here can be costly for clients. The most common pitfall involves a transfer that is considered under state law to effect a "change of ownership"[1] that triggers an increase to the property's assessed value for purposes of the local *ad valorem* property tax. This is especially true for any clients with real property located in California and Florida residents with real property in Florida.

In California, Proposition 13, passed in 1978, functions to (i) lock in the tax-assessed value of real property and (ii) cap any potential annual increase in the tax-assessed value from the previous year to 2%, until such time as the property undergoes a certain change of ownership. The tax-assessed value is first determined by the price at which property is originally acquired. This value is then used to determine property taxes in each subsequent year.

As an example, suppose Buyer 1 purchased a property 20 years ago at $150,000 and today the property is worth $1,000,000. The owner would be paying taxes based on the capped tax-assessed value of $222,892 instead of the fair market value of $1,000,000 -- an incredible difference resulting in significant tax savings. Now consider that in the same year Buyer 2 purchased a similar property in the same neighborhood as Buyer 1, but paid $950,000. Buyer 2's property taxes would be based on a $950,000 tax-assessed value, the price at original acquisition, even though both Buyer 1 and 2 own comparable properties. (Of course, going forward, Buyer 2 would benefit from the cap.) The cap applies to all California real estate, including commercial property, but it should be noted that legislation to remove commercial property from such protection has been proposed.

In Florida, the Save Our Homes amendment, passed in 1995, caps annual tax-assessed value increases of Florida residents' Homesteads to the lower of 3% or the change in the Consumer Price Index.

Change of ownership triggers reassessment of the tax-assessed value in both California and Florida. However, both jurisdictions exempt certain transfers. Florida exempts transfers (i) where the same person is entitled to the Homestead exemption (*i.e.*, a transfer into a revocable trust), (ii) between spouses, (iii) by operation of the Homestead Laws[2] of descent, or (iv) occurring upon death when the property passes to a legal or natural dependent. In California, Propositions 58 and 193, passed in 1986 and 1996, respectively, exempt from reassessment (i) all transfers between spouses and transfers by gift, sale, or inheritance between parents and children of (a) a primary residence and (b) up to $1,000,000 in "assessed value" of other property, and (ii) transfers between grandparents and grandchildren if the parents of the grandchildren are deceased.

Clearly, the Proposition 13 and Save Our Homes tax caps provide a wonderful benefit to clients. When advising and planning, we as advisors need to be aware and cautious not to propose any transfer or retitling of assets that may sacrifice or jeopardize such a powerful lifetime tax benefit without fully examining the consequences for our clients.

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[1] Cal Rev & Tax Code §§ 60 - 69.5; Fla. Stat. § 193.155(3)

[2] Fla. Stat. § 732.491

TREATMENT OF COOPERATIVE APARTMENTS AT DEATH

By Kasey Place

Cooperative apartments, also known as co-ops, are a type of home ownership that is generally associated with New York City, where they comprise approximately 75% of the housing inventory.[1] In reality, however, co-ops can be found across the U.S. and most advisors, no matter where they are located, will confront them from time to time in their practice. Therefore, it is important to have some familiarity with the cooperative structure and how co-ops are treated for tax and probate purposes.

A co-op interest consists of shares in the corporation that owns the building and a proprietary lease that allows the shareholder to occupy a particular apartment within that building. As a result, it is generally categorized as intangible personal property (rather than real property) for estate tax and probate purposes, which has important implications for decedents, especially so for those who are not residents or domiciliaries of the state in which the co-op is located.

First, a co-op outside of the decedent's state of residence typically won't be subject to estate tax by the state in which the co-op is located.

Example 1: Decedent was a Virginia resident who owned a co-op in New York. New York has a state estate tax, but with respect to non-residents it only applies to "real and tangible personal property having an actual situs in New York state".[2] Because the co-op is considered intangible personal property (and because Virginia has no estate tax), it will not be subject to state estate tax.[3]

Example 2: Decedent was a District of Columbia resident who owned a co-op in New York. Although the co-op will not be subject to New York estate tax, it will be subject to D.C. estate tax.

Second, a co-op outside of the decedent's state of domicile typically won't require ancillary probate. Note, however, that even though that is ostensibly the case in the District of Columbia, the D.C. Recorder of Deeds may require a foreign estate proceeding as a prerequisite to recording the Economic Interest Deed, which every D.C. co-op is required to file when an apartment changes hands.[4]

For the reasons described above, a co-op may be simpler to deal with at death for estate tax and probate purposes than real property. However, in other respects, the co-op can be more complicated. For instance, just because someone is named to receive the co-op under the decedent's Will or intestacy law doesn't mean he or she can actually take ownership and possession. Instead, such matters are typically left to the discretion of the co-op board. An advisor should review the by-laws and the proprietary lease for all relevant transfer restrictions and procedures.

In sum, estate planning attorneys and wealth advisors must be cognizant of the fact that co-op apartments are treated differently at death than other residences and must plan accordingly.

IPB IN THE NEWS …

- *"Military Families May Be Affected by New Tax Changes - Here's How"* by Doug Andre (October 10, 2019)
- *"IRS Provides New Relief Procedures for Certain Former Citizens"* by Doug Andre (September 12, 2019)
- "*Potential Tax Impacts of Changes to U.S. Citizenship Rules*" by Doug Andre (August 30, 2019)
- *The Best Lawyers in America 2020* Edition Recognizes Eleven IPB Attorneys and Carter Hood, IPB Partner, individually recognized for Closely Held Companies and Family Businesses Law, Tax Law, and Trusts and Estates (August 15, 2019)
- IPB's Estate Planning Practice Recognized by *Chambers & Partners in 2019 High Net Worth Guide* and Carter Hood, IPB Partner, individually recognized among DC practitioners by *Chambers & Partners in 2019 High Net Worth Guide* (July 12, 2019)

Past Issues of IPB Tax, Trusts & Estates

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[1] https://www.hauseit.com/co-op-vs-condo-nyc/#There Are More Co-ops than Condos

[2] NY Tax L §960(a).

[3] See New York Advisory Opinion TSB-A-11(1)M (Oct. 12, 2011) (A non-resident's estate was not subject to New York estate tax on a 50% partnership interest owned through the decedent's revocable trust, even though the partnership owned eight co-ops in New York).

[4] DC Municipal Regs. §9-515.2 ("A deed shall be filed by any entity that is subject to the Recordation of Economic Interests Act whenever a transfer of an economic interest in the entity occurs."); DC Code §42-1102.02(c) (defining "transfer of an economic interest" to include "every transfer of an interest in a cooperative housing association in connection with the grant, transfer or assignment of a proprietary leasehold or other proprietary interest").

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