

## Transferring Real Estate with Negative Capital

It is common for real estate to be held in a limited liability company (LLC) for limited liability protection, management, privacy reasons, and for tax purposes. Single member LLCs are generally disregarded for income tax purposes and multi-member real estate LLCs are generally taxed as partnerships, which allows for a flow-through and a single level of income taxation at the member level. Often the real estate LLC is owned by two or more family members and the older member is interested in passing down the equity interest to the younger members of the next generation.

While the transfer of a LLC membership interest may accomplish the client's goal of preserving and managing family wealth, there are important tax aspects of the transfer that need to be examined. It can be a mistake for lawyers to make transfers of such interests without reviewing whether the member has a negative capital in the entity. Negative capitals are common where real estate in the LLC is encumbered by a mortgage or debt and deductions, losses, or distributions were taken by the members in excess of their capital but for which they had *tax basis* because of the liabilities allocated to them. In these situations, what might appear to be a nontaxable gift (*currently, the Federal gift, estate and GST exemption is \$5,490,000 and donors can apply this exemption to make lifetime gifts without paying gift tax*) can actually trigger an *income tax* under the tax rules as a result of the debt relief and deemed distribution of cash.

There are ways to address this problem. Instead of outright gifts of negative capital interests, one might consider a transfer to a grantor trust for the benefit of younger members. A grantor trust allows for flow-through income taxation to the donor. Therefore, there is no shift of liabilities to trigger gain on the negative capital. If properly structured, the asset is excluded from the donor's estate, but still treated as being owned by the member for income tax purposes. The details of the grantor trust techniques and the future tax ramifications are beyond the scope of this alert, but care must be taken to work with a knowledgeable tax attorney to avoid an unexpected tax result.

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