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White Paper

Estate Freeze Technique:

Gift- or Sale-Leaseback

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Estate Freeze Technique: *Gift- or Sale-Leaseback*

What is it?

A sale-leaseback is a transaction where one party sells property to another party who then immediately leases the property back to the first party. A gift-leaseback is a transaction where one party gives property to another party who then leases the property back to the first party. A sale-leaseback is useful, for example, when a business owner needs to raise cash by selling assets but would like to continue to use those assets in his or her business. A gift-leaseback is an attractive strategy for someone who wishes to remove appreciating assets from his or her estate but needs to continue to use those assets.

If structured properly, a sale-leaseback transaction allows you, as the business owner, to raise cash by selling business assets, to continue to use those assets, to fully deduct the lease payments as a business expense, and to remove those assets from your taxable estate. The gift-leaseback may be a strategy to consider if you have assets that you expect to appreciate in the future, you would like to remove those assets from your estate, you need to continue to use those assets, and you have children or other beneficiaries to whom you would like to give the property. Typically, with a sale-leaseback, you sell a substantial physical asset (such as your plant or piece of major machinery) to a third party for cash. You then enter into a lease agreement (at a fair market rental) with that third party to continue to use that asset, and then fully deduct the lease payments as a business expense. The asset is removed from the balance sheet and you have additional cash to invest in the business.

With a gift-leaseback, you give a substantial physical asset (such as a medical office building in which you have your medical practice) directly to your children or to an irrevocable trust for the benefit of your children. You likely will incur gift tax on this transaction. You then enter into a fair market lease with your children or the trust to rent the building back. The lease payments are then deductible as a business expense. Your children or the trust receive the income from the lease payments and may be able to claim depreciation deductions with respect to the building. Because you no longer own the asset but merely lease it, the asset that may appreciate in the future is removed from your estate.

When can it be used?

Transaction needs to be structured and documented very carefully to minimize IRS scrutiny

The IRS has scrutinized both sale-leaseback and gift-leaseback transactions very closely to determine if the entire transaction is genuine and not merely disguised as a sale. If the IRS determines that the

transaction is not a sale but is really a loan, then the lease payments will not be fully deductible. If the transaction is recharacterized, the business owner will be able to deduct only that portion of the lease payment that was determined to be interest--just as with a loan. If the IRS determines that the transaction is a loan, then the purchaser of the building is considered a mortgagee and will not be considered the owner, and thus cannot deduct depreciation and expenses. The IRS will especially scrutinize transactions between related parties, such as family members or corporations and shareholders.

Terms of transaction must be negotiated at arm's length

All of the terms of the sale- or gift-leaseback must be negotiated fairly and arrived at in an arm's length manner. In other words, the sale price of the asset should be the fair market value of the property; the lease payments should be reasonable and based on comparable rentals; the financial arrangements should be straightforward; and the buyer should be the party to benefit from any future appreciation (and suffer the burden of any future loss in value) with respect to the property.

Lease terms very important

In both sale-leaseback and gift-leaseback transactions, the IRS will examine very closely the terms of the lease to make sure that the transaction is bona fide and has been negotiated in good faith. Therefore, the parties to a sale- or gift-leaseback should make certain first that there is a written lease agreement between the parties. Second, the terms of the lease should be the same as the terms of any standard commercial lease for that type of property. Third, the rental amount should be the fair market rental for that type of property, so the parties should obtain a qualified, independent appraisal of the market rental rate. Fourth, the lease agreement should specify that the terms of the lease will be renegotiated frequently (preferably every year) to adjust for changes in the fair market rental of the property. Finally, all the terms of the lease should be complied with strictly, and the agreement should provide that there will be penalties for late payments and other breaches of the agreement. These types of provisions demonstrate that the transaction is bona fide; however, it is not necessary that parties include every single term (such as late fees). The inclusion of these types of provisions is especially important when the transaction is between related parties, such as family members or a corporation and its shareholders.

Sale-leaseback should be necessary business operation

With a sale-leaseback, the IRS will also scrutinize whether the transaction is a necessary business operation or merely an attempt to shift the tax burdens and responsibilities. The lease should have a bona fide business purpose. The Tax Court has held that if the assets sold were used in the business, then this would be sufficient to meet the business purpose test. However, two Federal Circuit Courts of Appeal have rejected the Tax Court's approach. These two appellate courts found that where the lessee owned the property before the transaction, the subsequent rental of the same property after the sale was not "ordinary and necessary." Therefore, you should consult with an attorney to determine if you

live within the jurisdiction of either of these appellate courts. If so, then you may have to structure the transaction differently.

If trust is used, trustee should be completely independent from grantor of trust

If you would like to give or to sell property to your children, you might be hesitant to transfer direct ownership of the property to them, especially if they are minors. One solution is to set up a trust and name your children as beneficiaries. If you do set up a trust, it is extremely important that the trustee be completely independent, perhaps a bank or an independent fiduciary. The IRS will be extremely wary of either a sale- or gift-leaseback transaction where the trustee of the trust is related in some way to the person who creates the trust (the grantor).

If trust is used, property should not come back to grantor at the end of some period

If you decide to set up a trust for the benefit of your children and then sell or gift property to the trust with a leaseback provision, you should not have a provision in the trust where the property will revert (return) to you at some point in the future (called a reversionary interest trust). If there is such a provision in the trust agreement, then the IRS does not consider this arrangement to be a true sale or gift. The tax benefits of a gift- or sale-leaseback would not apply.

Tangible assets used in trade, business, or profession are best type of property to use in a gift- or sale-leaseback

The types of property you should use in a sale- or gift-leaseback are physical assets that you make use of in your trade, business, or profession, for example, a medical building that you use as an office for your medical practice. Other types of physical assets may include office equipment, land, machinery, or trucks. These are the types of assets that are rented or leased all the time by businesses and for which it is easy to determine fair market values.

Strengths

Sale-leaseback is a good way for companies to turn assets into cash

A sale-leaseback may be an excellent way for a company that is asset rich but cash poor to turn some of those assets into ready capital. The company would have the further benefit of being able to continue to use those assets. Most major airline companies, for example, use the sale-leaseback technique to finance their fleets of planes.

Example(s): Old Time owns a manufacturing plant that it estimates has a fair market value of \$1 million. Old Time would like to upgrade and modernize its plant but does not have sufficient cash flow to finance the modernization. Old Time would prefer not to mortgage the plant. One solution for Old Time would be to find a buyer and then do a sale-leaseback. Old Time could sell the plant for \$1 million, receive the cash up front, and then enter into an agreement with the buyer to lease the plant back at a fair market rental amount. If the sale-leaseback is structured properly, Old Time could fully deduct the lease payments as business expenses. They would then have enough money to modernize the facility.

Gift- or sale-leaseback can reduce size of gross estate

Either the sale-leaseback or the gift-leaseback may be used to reduce the size of your taxable estate. With both a sale and a gift, the asset is removed from your estate. With a sale, the property you receive in exchange for the asset you sold would likely be included in your gross estate. With a gift, a gift tax would have to be paid (if not covered by the gift tax applicable exclusion amount, formerly known as the unified credit) at the time of the gift. However, if the asset is appreciating rapidly, it may make sense for you to remove that asset as soon as possible. It's important to note that at your death, the value of all your taxable gifts made during your lifetime is added back into your gross estate. You are also given a credit for any gift tax that you have paid. However, any appreciation in the value of the gifts after the time of the gift is not included in your gross estate.

Example(s): Hal has a very successful internal medicine practice in Los Angeles. He currently owns a medical building in which he is the only tenant. The building is in a part of the city where real estate prices are appreciating rapidly. He has two minor children. He already has substantial assets and expects these assets to continue to grow in the future. He would like to remove some of these assets from his estate. A gift-leaseback may be an excellent way to accomplish this goal. He could set up an irrevocable trust and name his two children as the beneficiaries. He could then name a bank or other independent person as the trustee. He could gift the medical building to the trust and either use the gift tax applicable exclusion amount or pay the gift taxes on the value of the building if the entire exclusion has been previously used. He could then enter into a lease agreement with the trust to rent the building at a fair market rental. The rental payments would then flow through the trust to his children, and the future appreciation of the building would be removed from his estate.

Sale-leaseback and gift-leaseback may allow diversion of income from high tax bracket to low tax bracket

A sale-leaseback or a gift-leaseback of income-producing property may allow you to shift income from yourself (in a higher tax bracket) to your children or others (in a lower tax bracket).

Caution: Your potential federal income tax savings from transferring income-producing property to your children may be reduced by the kiddie tax. For 2008 calendar year taxpayers, unearned income above \$1,800 may be taxed at the parent's income tax rate. The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose unearned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose unearned income doesn't exceed one-half of their support.

Tradeoffs

Seller will have to pay taxes on gain at time of sale

In the case of a sale-leaseback, the seller of the property will have to pay the taxes on any gain realized. Therefore, if you own an asset with a low adjusted basis and you sell that asset, you will have to pay the taxes due just as with any other sale.

Example(s): The Old Time Manufacturing Company owns a plant with an adjusted basis of \$100,000. It plans to structure a sale-leaseback to raise cash to modernize the facility, and arranges to sell the plant for \$1,000,000. In the year of the sale, Old Time will have to pay taxes on the gain of \$900,000.

In a gift-leaseback, the donor may have gift tax liability

In a gift-leaseback transaction, when the donor makes the gift, a gift tax obligation may be incurred at the time of the transfer. There may also be gift tax liability in a sale-leaseback transaction if the selling price is less than the fair market value (FMV).

Example(s): Hal owns the building in which his medical practice is located. He would like to transfer ownership of the building to an irrevocable trust for the benefit of his children. He gifts the building to the trust. The building has an FMV of \$500,000. He has already fully used the gift tax applicable exclusion amount through past gifts. At the time of the transaction, Hal owes a gift tax on the \$500,000 gift. Similarly, if he had sold the building to the trust for \$200,000, then he would owe gift taxes on the \$300,000 difference.

Seller will not benefit from any appreciation in value of asset

One of the tradeoffs to doing a sale-leaseback is that the seller of the asset will not benefit from any appreciation of that asset in the future. One alternative to the sale-leaseback is to mortgage the property. This will also raise cash, and you can probably deduct the interest portion of the loan payments. You will also receive the benefit of any appreciation of the asset in the future. Therefore, if you are in a position where you may need the asset in the future, you should not do a sale-leaseback transaction. Simply mortgaging the asset may be a better way to go.

How to do it

Consult a competent and experienced legal advisor

As with any transaction of this type, a competent and experienced attorney should be hired to draft the necessary legal documents to document the transaction and especially the terms and conditions of the lease. If it is a gift-leaseback and you plan to set up a trust to receive the gift, then an attorney experienced in trusts and estates should be hired to draft the trust document. The requirements for establishing and maintaining trusts can be very complicated, and only an experienced attorney should handle these issues.

Appraiser should be hired to determine fair market value of assets and fair rental value

An independent, unbiased, and experienced appraiser should be hired to determine the fair market value of the asset that will be sold or given away. **Caution:** If the asset is sold for less than fair market value, it may be considered a partial gift, and gift tax may be due. The appraiser should also determine the fair market rental value of the asset. It is critically important that the rent be set at a market rate. The IRS scrutinizes these transactions very closely to see if the lease terms have been arrived at in a bona fide, arm's length manner.

Tax considerations

Income Tax

Tax must be paid at time of sale

In a sale-leaseback, if the property has been sold for more than its adjusted basis, then the seller must pay the full capital gains tax due at the time of the sale. There are no special tax breaks given to a sale-leaseback.

Lease payments may be fully deductible by lessor

If the sale-leaseback or gift-leaseback of a business asset is structured and documented properly, the lessor (the former owner of the property) can fully deduct the lease payments as an ordinary and necessary business expense. This may result in substantial tax savings for the lessor.

Lessee will have to report lease payments as income

The lessee (the person or entity to whom the property was sold) will have to report the lease payments as income. Depending on the type of property that is acquired, the lessee may be able to depreciate the asset and offset at least some of the lease income. If the lessee has financed the purchase of the asset, he or she may also have interest deductions to offset some of the income.

Estate Tax

Value of asset sold not included in gross estate of seller

If a sale-leaseback or a gift-leaseback has been structured and documented properly, then the asset transferred is not included in the gross estate of the seller. Instead, the consideration you received in exchange for the asset will be included in your gross estate, except to the extent you consume or otherwise remove it. If you own an asset that you think may appreciate in the future, a sale- or gift-leaseback may be an excellent way to remove that asset from your estate. You will still be able to use that asset in your business or profession. However, you should be aware that taxable gifts made during the lifetime of the donor are added back into the donor's gross estate. You are also given a credit for any gift tax that may have been paid. Furthermore, any appreciation in the value of the gift after the time of the gift is not included in your taxable estate.

Gift Tax

In a gift-leaseback, a gift tax may be due on fair market value of asset transferred

With a gift-leaseback, you may be liable for the gift tax on the fair market value of the asset transferred. You will either have to use the gift tax applicable exclusion amount or pay the gift tax due, if the entire exclusion has been previously used. The payment of the tax may pose a problem if you do not have sufficient liquid assets.

In a sale-leaseback, a gift tax may be due if property is sold for less than fair market value

With a sale-leaseback, if the property is sold for less than its fair market value, then the difference is considered to be a gift. A gift tax will be due on the transaction if the gift exceeds the annual gift tax exclusion amount and the applicable exclusion amount has been fully used.

Variations from State to State

When an asset has been sold for less than its fair market value, then the difference is considered to be a gift from both husband and wife in community property states

In a community property state, when the asset sold is community property and the sale price is less than the fair market value, the difference is a gift from both spouses.

In community property states, the signature of both spouses may be necessary to sell, lease, or mortgage community property

In certain community property states, the signatures of both spouses are required to sell, lease, or mortgage certain community property. Therefore, it will be necessary to get both spouses to sign any necessary documents to sell, lease, or gift property.

Questions & Answers

Why would a person or company do a sale-leaseback when they could simply mortgage the property?

There are two main advantages to selling an asset in a sale-leaseback transaction as opposed to simply mortgaging the property. First, in the business context, in a sale-leaseback, if the transaction is properly structured and documented, then the lease payments will be fully deductible as ordinary and necessary business expenses. With a mortgage, only the interest part of the payments would be deductible. Second, in the estate planning context, you would do a sale-leaseback if you wanted to remove the future appreciation of the asset from your gross estate. With a mortgage, you would still be considered the owner of the property, and it would be included in your estate at your death (though the mortgage debt would be deducted).

What are the factors that the IRS looks at to determine if a sale-leaseback is a legitimate transaction?

The IRS looks at several factors to determine if a sale-leaseback is a legitimate transaction or merely a loan disguised as a sale. Most importantly, the IRS looks at the lease agreement to see if rental payments are market rents, if the terms of the lease are standard commercial lease terms, if the terms of the lease are strictly enforced, and if the lease is in written form. The IRS also considers whether the sale price of the asset is the fair market price and reviews the transactions to see if there are any mandatory buy-back provisions (thus giving the asset back to the seller at some point in the future). If a trust is used, the IRS will look at the relationship between the trustee and the seller of the asset to make sure the trustee is completely independent of the seller.

Does the sale-leaseback transaction need to have a legitimate business purpose to pass IRS and Tax Court scrutiny?

Yes. The Tax Court has ruled that the sale-leaseback transaction needs to have a bona fide business purpose to qualify as a true sale. In one case, the Tax Court ruled that as long as the property sold and then leased back was actually used in the seller's trade, business, or profession, then this transaction would qualify as a legitimate business purpose.

But, some Federal Circuit Courts of Appeal have rejected the Tax Court's position. Instead, they held that the lease payments could not be ordinary and necessary expenses where the lessee actually owned the property prior to the transaction, and, thus, the sale transaction was not legitimate. Therefore, you should consult with your legal advisor prior to entering into a sale-leaseback. It is possible that if you live within the jurisdiction of either of these appellate courts, the transaction may have to be structured in a different manner.

Can there be a buy-back provision in the sale-leaseback agreement?

Yes. There may be an optional buy-back provision in the sale-leaseback agreement. However, the buy-back provisions need to be drafted very carefully. The terms of the buy-back should be in writing and should state that the purchase price of the buy-back option will be negotiated and based on the fair market value at the time of the repurchase. There should not be a mandatory buy-back provision in the sale-leaseback. If there is such a provision, the IRS may view the transaction the same as a loan and a mortgage.

In a gift-leaseback with the use of a trust, may the donor name anyone as the trustee of the trust?

No. The donor needs to be extremely careful about whom he or she names as the trustee of a trust in a gift-leaseback. The donor should certainly not name himself or herself as the trustee. The trustee should be completely independent of the donor and his family. For example, a bank or independent fiduciary could be used.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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