

## Estate Planning & Elder Law

### Estate Planning With Real Estate: Special Issues and Potential Pitfalls

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**A**s estate planning attorneys, we are often focused on the federal and state-level transfer tax consequences of an estate plan and accomplishing a family's goals. Our planning often involves real estate, but we are frequently less focused on the issues of environmental law, real estate law and real estate taxes that arise in this context.

This article discusses a number of issues that practitioners should be aware of when advising clients regarding an estate plan that involves real estate. Issues include New Jersey ISRA application, mortgage compliance, insurance issues, Realty Transfer Tax, Mansion Tax and Controlling Interest Transfer Tax. While estate planners themselves may not need to be experts in these areas, they need to know enough to recognize the issues that can arise, and to address these issues appropriately.

#### ISRA Requirements

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If there are (or were) business operations on the real estate involved in an estate planning transaction, and any of the businesses use (or used) hazardous substances, a transfer of the real estate may trigger the audit and cleanup requirements of the New Jersey Industrial Site Recovery Act ("ISRA," found at NJSA 13:1K-6, et seq).

Under ISRA, businesses which qualify as "Industrial Establishments" may be required to undergo environmental audits and cleanups upon specific "triggering events." The sale or transfer of the real property on which the Industrial Establishment operates is a triggering event. See NJSA 13:1K-8; NJAC 7:26B-1.1 et seq.

An Industrial Establishment is defined under ISRA and includes businesses with specified NAICS codes (these used to be called SIC codes), and the underlying real estate. See NJAC 7:26B-1.4. Businesses subject to ISRA include those that manufacture, transport, treat, store or dispose of hazardous substances and wastes. NJAC 7:26B-1.4. An Industrial Establishment includes all of the blocks and lots on which the business is conducted and any contiguous blocks and lots controlled by the same owner or operator that are vacant land or

that are used in conjunction with such business. For leased properties, an Industrial Establishment includes the leasehold and any external tank, surface impoundments (pits or excavations), septic systems, or other structures that provide or are used for hazardous substances or wastes.

If it is determined that a property or a business is subject to ISRA, and none of the possible waivers, exemptions or alternate compliance processes apply, then the business owner or operator must submit a general information notice to the New Jersey Department of Environmental Protection within five days after the triggering event, and is required to conduct certain environmental audits and/or a cleanup. Failure to comply with the requirements can result in substantial penalties or revocation of the transaction.

From an estate planning perspective, a determination that a property may be subject to ISRA often leads to a reconsideration of the proposed estate planning transaction and a thorough discussion of the potential environmental issues involved.

**Example — LLC creation.** Your client, Eli, owns a steel fabricating business. Eli also owns the real estate where the business operates and leases it to the business.

You recommend that Eli transfer the real estate to an LLC, in order to have limited liability protection and also so that Eli can begin a gifting program. Such a transfer could be an ISRA trigger, and as a starting point, requires research into whether the activities conducted by the business or the prior occupants of the property are subject to ISRA.

#### **Mortgage on the Property/Due on Sale Clause**

If a property being transferred is subject to a mortgage, the mortgage documents should be reviewed to determine whether a transfer will cause a technical default or violate any due-on-transfer clause. Some mortgage documents permit intra-family transfers for estate planning purposes, but many do not. If the mortgage documents prohibit such transfers, the client should consider obtaining lender consent prior to the transfer.

#### **Property and Casualty Insurance**

If there is a change in the ownership of a property, the client should change the property and casualty insurance on the property so that it reflects the new ownership. Transfers to LLCs, Qualified Personal Residence Trusts ("QPRTs"), Grantor Retained Annuity Trusts ("GRATs"), and sales to defective grantor trusts which involve real estate all will raise this issue.

#### **Title Insurance**

Certain estate planning transfers may affect the title insurance coverage on the property. Attorneys should confirm with the title company that a contemplated estate planning transfer of the real estate will not affect the title insurance coverage.

#### **Mansion Tax**

The New Jersey "Mansion Tax" was enacted in 2004 and expanded to include Class A commercial properties in July 2006. The Mansion Tax imposes a one percent tax for consideration recited in the deed in excess of \$1 million dollars on buyers of Class 4A commercial property, Class 2 residential property, cooperative units and Class 3A farm property (so long as the farm property that is conveyed includes a building or structure suitable for residential use). NJSA

46:15-7.2a. The various types of property classifications are found in NJAC 18:12-2.2. "Consideration" includes the value of any prior mortgage to which the transfer is subject or which is to be assumed and agreed to be paid by the grantee. NJSA 46:15-5-1(c).

**Example — Sale to a grantor trust.** Brandon owns six properties that will be included in a sale to an intentionally defective grantor trust transaction. One is a small strip mall that Brandon owns in his own name, with a value of \$3 million dollars and a mortgage of \$1.5 million dollars. As part of the estate planning transaction, Brandon will convey the property (subject to the mortgage) to a new LLC. This deed transfer will trigger realty transfer tax and a Mansion Tax of \$15,000 (one percent of the \$1.5 million dollars mortgage, which is included in determining the consideration). For a comparable example involving realty transfer tax on the termination of a partnership, see *Zimmerer v Clayton*, 7 NJ Tax 15 (1984).

#### **Controlling Interest Transfer Tax**

Enacted in July 2006, the New Jersey Controlling Interest Transfer Tax ("CITT") was enacted to prevent circumvention of the Mansion Tax by using real estate-owning entities to make nondeed transfers. The CITT imposes a one percent tax upon the sale or transfer of a controlling interest in an entity which possesses, directly or indirectly, a controlling interest in classified real property, if the consideration exceeds \$1 million dollars. NJSA 54:15C-1(1). In the case of an entity which owns classified real property and other property, where the equalized assessed value of the real property exceeds \$1 million, a transfer of a controlling interest in the entity will also trigger the tax.

The sale of a controlling interest may occur in one transaction or a series of transactions. NJSA 54:15C-1(2). Transactions occurring within six months are presumed to constitute a single sale or transfer. Purchasers who are related parties (pursuant to the attribution rules of Internal Revenue Code §318) are presumed to be acting in concert. Also, the CITT does not apply to any transaction that would be exempt from the realty transfer tax (under NJSA 46:15-10). See NJSA 54:15C-1(2)(c)(3).

Regulations issued in July 2008 provide a number of examples of the CITT's applica-

tion. See NJAC 18:16A-1.1, et seq.

**Example, sale to grantor trust.** Mario is the 100 percent owner of an LLC which owns an office building valued at \$3 million dollars. Mario intends to gift a 10 percent membership interest in the LLC to a new grantor trust that Mario has established for the benefit of his family. Mario also intends to sell an 80 percent membership interest in the LLC to the trust in exchange for a \$2 million dollars promissory note. Absent other planning, the sale by Mario to the grantor trust involves consideration of \$2 million dollars and could be subject to the CITT, triggering a tax of \$20,000 dollars.

**Example 6 of the regulations** (NJAC 18:16A-1.5) involves a helpful example where a "mere change in identity" of the partners but no change in "beneficial ownership" of a property does not trigger the CITT. In the example, a limited partnership with four partners is dissolved, and the four partners transfer their former limited partnership interests to a newly created LLC. The transfer is not subject to the tax. While the statutory underpinnings for a "mere change in identity" exception are not clear, it is a good result for the taxpayer and raises the question as to what other types of transfers may be considered to be "mere changes in identity."

It is important to note that the New Jersey CITT is substantively different from New York's controlling interest tax, and also raises many questions about whether a particular transaction will be subject to the tax. There may be a number of planning opportunities to structure estate planning transactions such that the CITT will not apply. A relatively simple example might be to sell a 49 percent interest in a real estate entity to a grantor trust this year and sell another 49 percent interest 12 months later. Another example might involve making a gift of a portion of the real estate such that the total consideration is less than \$1 million dollars. In many ways, GRATs and sales to grantor trusts do not appear to be the types of transactions that the CITT statute was intended to reach, and careful planning may lead to estate planning transactions that do not unnecessarily trigger the tax.

Estate planning attorneys should be cognizant of the above issues whenever an estate plan involves transfers with real estate so they can properly advise their clients. ■