New Jersey Law Journal

VOL. CLXXXVII– NO.6 – INDEX 421 FEBRUARY 5, 2007 ESTABLISHED 1878

# Estate Planning

## Purchasing Commercial Real Estate Through an LLC

### A hub and spoke structure removes a significant value from the owner's estate

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Those individuals who currently own or are contemplating the purchase of rental or commercial real estate may be well-advised to consider forming a hub and spoke entity structure. Owning rental or commercial real estate in an entity such as a limited liability company, as opposed to individual ownership, helps insulate the owner from personal liability, streamlines the ownership of the real estate and administrative expenses and provides a great opportunity to remove significant value from the owner's estate, which can create significant estate tax savings.

The plan would begin with the creation of an LLC or S corporation. For purposes of this article, we will assume that an LLC is used. This LLC will be the hub entity (the "Hub LLC") from which the owner(s) can invest in multiple real estate ventures. This Hub LLC would, in turn, own 100 percent of various other LLCs. The individual LLCs (the "Spoke LLCs") owned by the Hub LLC would each own a separate piece of property. The Spoke LLCs will not need to file their own income tax returns as they are disregarded entities for tax purposes. Their income will flow through to their owner (the Hub LLC). The Spoke LLCs will protect each property from liabilities associated with the other properties. As long as the form of ownership is respected (e.g., with each LLC having its own bank account to which rental payments are deposited and from which expenses associated with the property owned by that particular LLC are paid), liabilities associated with one property should not attach to the other properties.

For properties already owned by the client, it will be important to assess whether there are environmental issues associated with a transfer of the properties. For example, the transfer of commercial manufacturing facilities in New Jersey could trigger ISRA compliance issues. An owner should obtain lender consent to the transfer of any property secured by a mortgage to avoid an acceleration of the mortgage. Additionally, as to any existing real estate, the owner must change the property and casualty insurance covering the property to reflect the new owner. This is critical to maintain insurance protection.

To accomplish estate tax planning through this structure, the Hub LLC could be created with two classes of members: a 1 percent voting membership interest, owned by the parents (one or both of them, alone or together with a third individual selected by them); and a 99 percent nonvoting membership interest, which could be owned by the parents or partially by the parents and partially by a trust for the children. The trust could be structured to permit distributions among children and grandchildren. This would allow the owners to potentially shift income to children and/or grandchildren who are presumably in lower income tax brackets (once they are beyond the age of the kiddie tax). It would also be a mechanism to remove any interest in the real estate from the owner's taxable estate, together with future appreciation and the income associated with the interest held by the trust.

Where real estate is already individually owned by a client and is being transitioned to the structure described above, care must be given to the gift tax consequences involved with a transfer of an interest in the Hub LLC (initially owned by parents) to children or a trust for their benefit. Discounts can be taken, however, to reflect the gifted interest's lack of control and lack of marketability. Discounts typically range

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from 20 to 40 percent. See e.g., *Weinberg v. Commissioner*, T.C. Memo 2000-51 (where an interest in a family limited partnership funded with an apartment complex was discounted by 20 percent for lack of marketability) and *Estate of Hillgren v. Commissioner*, T.C. Memo. 2004-46 (2004) (where an interest in a family limited partnership funded with marketable securities and real estate was given a 24 percent discount for lack of marketability and a 15 percent minority interest discount). The value of all gifts should be confirmed through an appraisal both of the real estate in the Spoke LLCs and a separate appraisal of the appropriate discounts for lack of marketability and lack of control attributable to the membership interests. The valuation discounts enable parents to gift more assets each year without exceeding their $12,000 annual exclusions or $1 million gift tax applicable exclusions.

To illustrate the leveraged gifts, assume that a Hub LLC is worth approximately $1 million. Assuming a 33-1/3 percent discount, each parent could gift a 3.6 percent interest to each child, or to a trust for their benefit, and he or she will leverage the use of his or her $12,000 annual exclusions. If a taxpayer has three children, he could give a 10.8 percent Class B (nonvoting) membership interest to a trust for the benefit of the three children using his combined $72,000 of annual exclusions ($24,000 x 3 beneficiaries). A gift of a 10.8 percent Class B membership interest will only be valued at $72,000, calculated as follows:

$1M value x 10.8% LLC interest = $108,000
Less 33-1/3% minority discount = $ 36,000)
Value of Gift = $72,000

No federal gift tax would be owed as a result of the $24,000 annual gift exclusions. Under this approach, for each $24,000 gift that is made, $36,000 of current value plus future appreciation (and the future income generated by the gifted interests) escapes gift and estate taxes. This would allow the taxpayer to transfer assets with an underlying value of approximately $36,000 out of his name each year as annual exclusion gifts. The IRS may question the applicability of discounts for lack of marketability and lack of control when valuing minority interests and clients should be advised as to this risk.

For real estate to be purchased now or in the future, parents could create a new Spoke LLC to be owned by the Hub LLC for such real estate and could loan money to the LLC to fund the purchase price. Since the parents would not have contributed the monies to the LLC towards the purchase as equity, the LLC would have very little value such that a transfer of an interest in the Hub LLC to children or a trust for their benefit would have little, if any, tax consequences. The note could be repaid over time with rental income received by the Spoke LLC.

The IRS takes the position that for an individual who creates an entity and thereafter gifts an interest in the entity to children but retains any control over the entity as a voting member, the underlying assets owned by the entity will be included in his or her estate at death, regardless of any gifting of membership interests to children. This holding involved an entity funded with marketable securities (not an operating entity); however, there is a risk that the holding could be applied to a real estate company in the future. In light of that case, consideration should be given as to who the voting member(s) of the hub entity will be. If the structure is used for newly purchased real estate to be set up in the hub/spoke structure from the inception, this should not be an issue, since no transfers will be involved.

With respect to the Hub LLC, for federal tax purposes, the LLC will be taxed as a partnership if there are two or more owners, unless it makes an election to be treated otherwise. If the LLC is treated as a partnership, all of the LLC's income and losses would flow through to its members to be reported on their individual tax returns. A single member Hub LLC will be taxed as a sole proprietorship unless it elects to be treated otherwise. The Spoke LLCs will be disregarded entities for tax purposes. As such, they will not need to file their own seperate tax returns.

The Hub LLC and Spoke LLCs would be created by filing a Certificate of Formation with the Secretary of State's office setting forth the entity's name, registered agent for service of process and date of dissolution. An operating agreement could be prepared for each entity with the LLC's internal rules of governance. With respect to the Hub LLC, this could incorporate buyout provisions which would deal with what happens in the event a member dies or transfers an interest, voluntarily or involuntarily.

This structure described above minimizes administration costs and streamlines the ownership of real estate, while maximizing the liability protection afforded a taxpayer and accomplishing income and estate tax planning. ■