

Nothing is Certain with Death and Estate Taxes

*Experts debate whether
the unexpected demise of
the 'death tax' will breathe
new life into the 1031
exchange market in 2010*

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For those with the wherewithal to worry about it, it used to be that nothing in death was certain except estate taxes. Until this year, that is.

Thanks to a nearly decade-old tax law, a repeal of the estate tax for this year only means that if somebody dies in 2010, no matter how substantial his or her estate, the tax man goes away empty-handed.

Aside from the fact that one needs to be dead to take advantage of it, sounds great, right? In addition, the estate tax holiday has potential implications for the 1031 exchange market, which for the past couple of years has been, well, moribund. But opinion is mixed on whether the estate tax repeal improves the outlook for exchanges.

Barbara Rosenbaum, an executive vice president and former head of the tax division at Gumbiner Savett Inc., a certified public accounting and advisory firm, believes the repeal — effectively a zero estate tax rate — could very well heighten the market for 1031 exchanges.

"Under the 2010 estate tax repeal scenario, a beneficiary of an estate ends up with a carryover basis from a decedent," Rosenbaum said. "I think that a beneficiary that would be holding this low-basis inherited real estate would find a 1031 exchange very appealing."

The issue comes about as a consequence of the 2001 Economic Growth and Tax Relief Reconciliation Act, which contained a provision allowing for the one-year estate tax repeal. But few tax experts actually expected it to go into effect. When it did, most of them were "beyond surprised," Rosenbaum said.

"The pundits in accounting and the legal and

insurance communities had expected Congress to act before the end of 2009 and extend the '09 limits and rates through 2010 to get rid of any uncertainty," she said.

Daniel Oschin, managing director of **BGK-Integrated Group**, called it a "nebulous" issue in which the answer depends on a lot of other things. He thinks the estate tax repeal probably **See TAXES, page 16**

hurts the market for exchanges in 2010 because it allows more flexibility in what people do with their taxes.

"After that, it depends on what the government does," Oschin said. "A lot of people think taxes will be higher and so a 1031 will be more appealing."

It's a Democratic administration in Washington, he observed. On the other hand, if the administration needs Republican votes, any effort to hike taxes may be dead on arrival.

"Raising rates is not going to excite a lot of people," he said. "In this particular circumstance, even though there's some money to be gained by the government, it may not be enough to offset the political risk."

Date of Death

Rosenbaum explained that the estate tax is a "date of death" concept. The estate tax is applied to the total fair market value of the decedent's assets, less the debts he or she might have as of the date of death.

However, the tax can be reduced by an exemption, which has increased incrementally from \$1 million in 2002 to \$3.5 million in 2009. Meanwhile, the maximum estate tax rate decreased during that period from 50 percent in 2002 to 45 percent last year.

On Jan. 1, 2011, the exemption level shrinks back to \$1 million, with a top tax rate of 55 percent.

"Until we got to this no estate tax moment," Rosenbaum said, "when there was a death, all the property in someone's estate got stepped up to the fair market value at the date of death. If you had bought a piece of real estate for \$1 million 20 years ago, passed away owning it, and the fair market value was \$20 million, the person who inherited the property got a \$20 million basis in that property."

That's the amount that was subject to estate tax. Under the 2010 estate tax repeal scenario, there's no step-up in basis to the fair market value. Therefore, in Rosenbaum's example, if someone purchased a property for \$1 million 20 years ago and passes away in 2010, whoever inherits the property has a basis of \$1 million.

"If the property is worth \$20 million, they



would probably be looking to do a 1031 exchange as opposed to the selling the property and recognizing that gain," she said.

At the same time, Rosenbaum noted it hinges on whether the 2010 estate tax repeal is allowed to stand.

"Right now, the estate tax is zero, unless we have retroactive reinstatement," she said.

If that occurs, which is a possibility, Rosenbaum believes it would adversely affect the appeal of a 1031 exchange because of the step-up in basis.

"Unless there was some additional depreciation," she said, "a 1031 exchange would be of no interest."

Bringing Life to a Dead Market

Other experts, however, do not believe that even the tax's demise for this year will breathe new life into the 1031 exchange market.

Real estate attorney J. Timothy Scott, a partner in **McKenna Long & Aldridge LLP**, for one, doesn't see the zero estate tax goosing exchanges.

"My basis analysis is that the tax rate for the estate tax is not going to impact the number of 1031 deals except in the rare circumstance of someone who wants to hold onto a property," Scott said. "And that motivation would be holding onto the property, not taxes."

Nor does he see it necessarily affecting the number of exchanges even if the estate tax comes "roaring back" next year. The estate tax is a tax on value, not on gain, he noted.

"First of all, if you die this year it's not going to matter," Scott said. "If you die next year, frankly, I don't see it mattering because if you die next year with a tax rate of 50 percent, what good would it have done you to do a 1031 exchange this year?"

What a 1031 did was defer one's gain, he said, so what the individual would be doing is comparing what the estate tax is over the next few years, if he or she is old enough to worry about dying in the near future, with what the personal income tax is this year.

"If you judge the personal income tax this year will be higher than the estate tax next year, you would go ahead and do a 1031 exchange," Scott said. "If you judge the personal income tax is lower than the estate tax next year, you would want to sell the property this year and pay the tax hit."

Indeed, Oschin said he's seeing owners who are facing foreclosure and other difficulties who are opting simply to pay their taxes rather than try to do an exchange.

"For the first time in a long time, I'm hearing people say, 'I've got enough other tax issues that can offset this that I'm willing to accept this loss,'"

he said. "The availability of debt, the velocity of the market and issues like that have far greater impact on exchanges than this tax issue will."

Doing a 1031 exchange long has been popular with commercial real estate investors because it allows them to defer their capital gains taxes. Over the past couple of years, however, the industry has been deadlier than a doornail.

Oschin said the 1031 market did a little better in the second half of 2009 than in the first half, but it's still only 5 percent of what it was. Most of that is multifamily and properties less than \$5 million, he added.

"The institutional-quality assets are not exchanging," Oschin said. "It's at an almost absolute standstill."

Scott attributes the deathly quiet in the 1031 market to the fact that nobody knows what anything is worth or how many buyers are out there. Financing also is an issue, he said.

"Even if you had a buyer, who's going to finance the buy side of the 1031?" he said.

Rosenbaum said 1031 exchanges often were done when fair market values were accelerating rapidly. The few 1031 deals she sees today have been done by people who have held property for a long period of time and want to get into a less management-intensive situation, such as a triple-net-leased property.

Large Estate Market

While estate taxes drive only a very small portion of the exchange market, commercial real estate sales in general are a different matter. Although nobody appears to track it, Oschin said a large amount of sales occur as a result of estate taxes.

"People die, heirs inherit property and they don't want the property," he said.

Scott noted people often have to sell property in order to pay the estate tax, which can be quite hefty.

"Many people who die leave their most substantial assets in property or a business or some other non-liquid form," he said. "Even if it's in stocks and bonds, you often have to sell those to pay the taxes."

Rosenbaum said she does not see clients needing to sell property to pay estate taxes in **Gumbiner Savett's** practice, although she is sure this happens elsewhere. With proper forethought and preparation through techniques such as life-time transfers and life insurance, she said, there never should be an unplanned need to dispose of commercial real estate or other assets.

"If all the things are dealt with and some planning is done while the taxpayer is alive, you

wouldn't find yourself in a place where you need to dispose of a piece of property to pay your estate tax, unless that's the plan," Rosenbaum said.

All this could be moot if Congress acts to reinstate the estate tax retroactively. According to Rosenbaum, legislation is anticipated that would reinstate the estate tax to Jan. 1, 2010. However, she said such legislation almost certainly would draw legal objections.

"Someone who has a large estate where a huge amount of money is at stake will be challenging any retroactive reinstatement," she said. "We're back to the pundits, but the thinking is that the courts will deem any retroactive reinstatement to be constitutional."

It's not just theoretical. Rosenbaum said Gumbiner Savett has a client who has passed away since the first of the year, and there will be a significant estate tax due if it is reinstated. She said the firm would work with the executor of the estate and the executor's legal counsel to consider the options.

"It's a very uncertain environment that we're working in," Rosenbaum said. "Estate tax is due in nine months from the date of death. We're going to sit and see what happens and decide what to do."

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