

A Reprint from *Tierra Grande*, the Real Estate Center Journal



The Economic Growth and Tax Relief Reconciliation Act of 2001 provides for a reduction in the estate tax followed by its complete elimination. The elimination of the estate tax has both costs and benefits for real estate heirs.

A major benefit is that starting in 2010 assets, such as real estate properties, will no longer be taxed as they pass from one generation to the next. However, a new cost will emerge — capital gains taxes will be payable on appreciated properties when they are sold by heirs, and also may be payable on highly leveraged real estate when it is transferred to heirs.

The phaseout begins in 2002. The highest estate and gift tax rates slowly drop from 55 percent to 45 percent by 2007. The minimum size of an estate subject to the estate tax rises from \$675,000 to \$1 million in 2002, and continues to rise gradually until it reaches \$3.5 million in 2009. The estate tax is eliminated in 2010. The gift tax will remain in the law.

STEP-UP IN TAX BASIS UNDER NEW LAW

An important component of the estate tax for beneficiaries receiving real estate is the tax basis of the property. Generally, gain or loss on the sale of property is equal to the sales price less the tax basis of the property. Under existing law, property received from a decedent's estate generally has a "stepped-up" basis,

meaning the basis is equal to the fair market value on the date of the decedent's death (or an alternate date if elected) rather than the decedent's tax basis. The decedent's adjusted basis would typically be the original cost increased by improvements and decreased by tax depreciation.

The step-up enables the beneficiary to avoid capital gains tax on any appreciation on the property that occurred prior to the decedent's death. In addition, it permits the estate to avoid capital gains tax when appreciated property is distributed to an heir.

Old Tax Law

\$8,000,000	Estate tax value	Not taxable
\$8,000,000	Heir sells property immediately	\$8,000,000
8,000,000	Heir's tax basis	3,000,000
\$0	Heir's capital gain	\$5,000,000

New Tax Law

CARRYOVER TAX BASIS UNDER NEW LAW

Starting in 2010, inherited real estate will have a tax basis equal to the lesser of the decedent's adjusted basis or the fair market value on the date of death. Thus, for appreciated properties, the decedent's adjusted basis will "carry over" to the heir.

For example, assume a decedent owned real estate valued at \$8 million with an adjusted basis of \$3 million. Prior to 2010, the basis is stepped-up to \$8 million fair market value. An estate tax might be payable on the \$8 million

value, but the estate would pay no capital gains taxes. When the heir sells the property, capital gains taxes would be owed only on appreciation in excess of \$8 million.

Starting in 2010, the heir would pay capital gains tax on \$5 million (\$8 million sale price minus the \$3 million carryover basis), as shown in the example. No estate tax would be owed.

There are two modifications to the carryover basis rule. First, there can still be a step-up to \$1.3 million in total. The \$1.3 million cap can be increased by any unused capital loss carryover, net operating losses or casualty-theft losses. Second, the spouse of the decedent will receive an additional \$3 million step-up in basis (for a total step-up of \$4.3 million).

IMPACT ON HIGHLY LEVERAGED PROPERTIES

Beginning in 2010, estates owning highly leveraged real estate with a low tax basis would have to pay capital gains tax at the time the property is transferred to the beneficiary. The estate is viewed as having sold the property, because of the heir's assumption of the liability. The estate realizes a gain to the extent that the liability exceeds the estate's tax basis in the property.

Assume the same facts as in the above example. In addition, assume the property is subject to a non-recourse mortgage of \$7 million. Prior to 2010, an estate tax might be payable on the \$1 million net value (\$8 million minus \$7 million), but no capital gains taxes would be owed by the estate. When the heir sells the property, capital gains taxes would be payable only on appreciation above \$8 million. Starting in 2010, however, the estate would pay capital gains tax on \$4 million (\$7 million debt over \$3 million basis). The heir's basis would become \$7 million and the heir

would have to pay capital gains tax on any future sale price above \$7 million.

Tax rules and computations under the new estate tax are complex. Consultation with an accountant, attorney or real estate professional is recommended. ♣

Dr. Stern (stern @Indiana.edu) is a research fellow with the Real Estate Center at Texas A&M University and a professor of accounting in the Kelley School of Business at Indiana University.



LOWRY MAYS COLLEGE & GRADUATE SCHOOL OF BUSINESS

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

<http://recenter.tamu.edu>
979-845-2031
800-244-2144 orders only

Director, Dr. R. Malcolm Richards; **Associate Director**, Gary Maler; **Chief Economist**, Dr. Mark G. Dotzour; **Senior Editor**, David S. Jones; **Associate Editor**, Nancy McQuiston; **Assistant Editor**, Kammy Baumann; **Editorial Assistant**, Ellissa Bravenec; **Art Director**, Robert P. Beals II; **Circulation Manager**, Mark W. Baumann; **Typography**, Real Estate Center; **Lithography**, Wetmore & Company, Houston.

Advisory Committee

Jerry L. Schaffner, Lubbock, chairman; Celia Goode-Haddock, College Station, vice chairman; Joseph A. Adame, Corpus Christi; David E. Dalzell, Abilene; Tom H. Gann, Lufkin; Joe Bob McCartt, Amarillo; Catherine Miller, Fort Worth; Nick Nicholas, Dallas; Douglas A. Schwartz, El Paso; and Larry Jokl, Brownsville, ex-officio representing the Texas Real Estate Commission.

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, \$20 per year.

Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, the Lowry Mays College & Graduate School of Business or Texas A&M University.