

Real Estate and the Estate: Wealth Transfer Strategies for Illiquid Assets

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The federal government imposes estate tax on the “fair market value” of US real estate—even if the owner is not a US citizen or resident at the time of death. Similarly, states may impose estate or inheritance tax on real estate located within their borders. Furthermore, real estate outside the US may be subject to federal and state estate taxes if the owner was a US citizen or resident at the time of death.

In some states, the combined federal and state estate tax can amount to 53% (or more) of the property’s fair market value. Estate taxes are payable by the owner’s estate to the government in cash no later than nine months after the owner’s death. For an estate that consists primarily of illiquid interests like real estate, paying the tax can be difficult.

The Liquidity Problem

A property’s fair market value is generally the amount a willing buyer would pay a willing seller, assuming that neither party is under compulsion to buy or sell and both are aware of all relevant facts.

In most cases, fair market value is determined as of the owner’s death. The executor settling an estate that consists largely of real estate probably does not have enough time to liquidate properties to pay the estate taxes when they are due—unless the executor is willing to sell for less than fair market value. Such a “fire sale” might raise fiduciary issues for the executor.

When a threshold percentage of the real estate owned by the decedent is part of a closely held business, the executor may be able to defer payment of estate taxes attributable for that portion for up to 14 years under Section 6166 of the Internal Revenue Code. Otherwise, the executor must use the estate’s liquid assets (including life insurance proceeds, if any) or borrow from third parties to pay the taxes due within the limited time frame allowed by law.

The Valuation Problem

Part of the problem with real estate is that its worth is inherently subjective: There are no market quotes available to establish value. When an owner

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dies, the executor is required to file a tax return listing each property and its appraised fair market value, which must meet the willing buyer–willing seller test. If the government disagrees with the estate’s appraiser, it can seek its own appraisals. Thus the valuation battle begins.

But the valuation problem can be more than a matter of differences of opinion. Consider timing. If a real estate owner dies in the midst of a real estate bubble, then the fair market value could be quite high—perhaps more than the executor can fetch in an arm’s length sale a year or two after her death. Assume she died owning a commercial property free of debt that had a fair market value of \$10 million, duly reported by the executor at that value on her estate tax return. If commercial real estate values falter and the executor sells the property for \$9 million, she may not be able to obtain an estate tax refund based upon the sale price. At best, the executor may be able to recognize a capital loss, for income tax purposes, of \$1 million—the difference between the sale price and the \$10 million “stepped-up” basis of the property.[†]

The Benefits of Lifetime Transfers

An owner can seek to avoid—or at least mitigate—estate tax issues by transferring property interests during his lifetime, structuring it as either a gift or a sale. A gift may be subject to federal gift tax, which can amount to as much as 45% of the value transferred. (Although many states impose an estate tax, the vast majority do not impose a gift tax on top of the federal gift tax.) Generally, a sale is potentially subject to gift tax only if the seller receives consideration of less than the property’s fair market value.

There are several reasons why lifetime transfers—whether by gift or by sale—of real estate may be preferable to transfers at death:

- First, an owner can significantly reduce the tax burden by transferring property when values are in a lull. Of course, lifetime transfers are subject to the willing buyer–willing seller test.
- Second, an owner may transfer less than his whole interest in a property, mitigating the valuation problem. For example, an individual who owns a warehouse with an appraised value of \$10 million could transfer an undivided 10% interest to his children or to an irrevocable trust set up for their benefit. Has the owner made a gift of \$1 million (10% of the \$10 million appraised value) for transfer-tax purposes? Well, a hypothetical willing buyer might not be willing to pay \$1 million for that interest. Any savvy buyer would recognize that she would own the property jointly with the seller—whose approval as co-tenant would be needed for a sale, mortgage, or other transaction. The buyer might, however, be willing to pay \$800,000 for that interest, depending upon the circumstances. Many court decisions support this type of fractional interest discount. In sum, the transfer of an undivided interest, whether by gift or by sale, could reduce an owner’s estate by more than the value of the interest actually transferred.[‡]
- Third, the gift tax can be cheaper to pay than the estate tax, even though the federal tax rate is the same for each. Gift tax is imposed only on the assets that the donee actually receives, whereas estate tax is imposed on all assets owned by the decedent at death. Assume that a real estate owner wants to transfer \$10 million of value to her children. She has used all of her otherwise

[†] The income tax basis of property acquired from a decedent within the meaning of Internal Revenue Code (Code) Section 1014(b) generally will be stepped up—or down—to the fair market value of that property on the date of the decedent’s death. This rule does not apply to certain types of property, notably “income in respect of a decedent,” which includes qualified plan benefits, payments due under installment sale contracts, and the like. If the executor elects “alternate valuation” in accordance with Code Section 2032, the basis of assets acquired from the decedent will be adjusted to reflect the fair market value of the property on the date that is six months after the date of the decedent’s death, although property sold or otherwise disposed of after death but prior to the alternate valuation date will be valued as of the date of disposition. Alternate valuation is not available unless both the value of the gross estate and the amount of estate tax payable will be reduced by virtue of the election.

[‡] In some cases, commercial real estate will be owned through an entity, rather than directly. In such cases, a transfer of an interest in the entity may warrant a discount for lack of marketability and, if the interest is a minority interest in the entity, for lack of control. The amount of these discounts should be determined by an experienced professional business appraiser, and could amount to 30% or more of the value of the interest transferred, depending upon the circumstances.

available gift- and estate-tax exclusions, and the effective gift- and estate-tax rate at the time of the transfer is 45%. If she makes the transfer during her lifetime as a gift, the amount of gift tax owed will be \$4.5 million (\$10 million × 45%, the gift-tax rate). The \$4.5 million of tax paid will leave her estate and will not be subject to estate tax upon her death—if she survives the date of the gift by at least three years.[§] On the other hand, if she were to transfer that same \$10 million to her children at death, she would need nearly \$18.2 million of total assets in her estate. After paying an estate tax of \$8.2 million (\$18.2 million × 45%, the estate-tax rate), she

would have \$10 million left to transfer to her children. Lifetime giving is even more beneficial in those states with a state estate tax but no state gift tax. So what's the catch? Aside from the three-year survival requirement, current law provides that the federal estate tax (and consequently most states' estate taxes) will go away—but only for individuals who are “lucky” enough to die in 2010. Thus, if current law remains in effect, those individuals who paid gift tax during their lifetimes—in many cases for the express purpose of avoiding a potentially higher future estate tax—and then die in 2010 will have paid that lifetime tax unnecessarily.■

§ Code Section 2035(b) provides that a decedent's gross estate must be increased by the amount of any federal gift tax paid by the decedent or his estate on any gifts made by the decedent or his spouse within three years prior to the decedent's death.

|| There may be a drawback for certain individuals who make taxable gifts even if they don't die in 2010. That drawback arises from the difference between the lifetime applicable exclusion amount—currently \$1 million—and the estate-tax applicable exclusion amount—currently \$2 million, but scheduled to increase to \$3.5 million in 2009. Let's modify our example in two respects: First, assume that our donor has made no prior taxable gifts; and second, assume that our donor wants to transfer property valued at \$2 million, rather than \$10 million, to her children. If she made a gift of that property today, the first \$1 million of value would not be subject to gift tax due to her lifetime applicable exclusion, but the next \$1 million of value would trigger a gift tax of \$450,000 (or 45% of \$1 million). On the other hand, if the decedent waited until death to transfer the property, the transfer would not be subject to estate tax, even if she died before 2010, due to the higher \$2 million estate tax applicable exclusion amount—but only if the property does not appreciate in value prior to the decedent's death. The current uncertainty about the future of the gift and estate taxes—not necessarily repeal, but the prospect of major changes in the applicable exclusion amounts or tax rates, or both—makes lifetime giving a complicated and risky game.

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