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Capital Gains, Real Estate, and Strategies for the Final Frontier

& Celebrity Estates

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It can be a drag not being able to sell property simply because one is hoping for or expecting a stepped up basis if that property is still held at death.

But is an investor completely restricted? Aren't there a few loopholes through which an investor can safely transfer non-residential real estate during life without incurring capital gains?

Yes, of course. It is possible to utilize 1031 like-kind exchanges which are specifically permitted under the Internal Revenue Code.

In addition, because of the many restrictions on the uses of 1031 exchanges, there are also some new variations such the tenancy in common (TIC) and umbrella real estate investment trusts (UPREITs) which may facilitate transfers.

Necessity is the mother of invention and new and evolving planning tools to allow for the transfer of real estate investments without incurring capital gains come with rules and risks.

In the context of what we expect ahead, planning for what is left of the estate tax may be far less critical than planning for the area where the real action and savings and attention will lie, i.e., on the reduction of capital gains and the need to shift the geographical nexus of assets out of those domiciles that impose estate and or inheritance taxes at the state level.

As a result, these new realty transfer techniques may become key financial planning tools of the future.

To Sell or To Hold

Holding real estate investments until death to obtain a stepped up basis is not always preferable. Investors holding appreciated real estate assets may prefer selling real estate during their lifetime for any number of reasons.

The time may be right to sell. Maybe the market is at a high, or poised to go lower. Or an investor simply wants to move on to some other more attractive investment or business venture. Or the real estate is part of a larger business transaction. Or the real

estate is associated with some potential liabilities, environmental or otherwise. Or it makes sense to sever ties to a state with high taxes.

The dilemma is that by holding an asset until death, it could pass to heirs with a stepped-up basis instead of incurring a liability of 15% or 20%. This of course assumes that the estate tax repeal will not be completed and that the stepped-up basis will remain with us in 2010 and beyond.

If there is no stepped up basis, then holding appreciated investments will defer taxation but not avoid it. Moreover, if capital gains are at a relatively low point right now, then there is, perhaps, more potential for capital gains to rise in the future rather than be reduced further.

After The Abyss

Australia actually experienced an estate tax repeal in 1979 and researchers have determined that taxpayer mortality exhibited unusual “elasticity” to conform dates of death with favorable tax outcomes.

Writing for the Tax Foundation in 2006 (“Disturbing Questions About the Estate Tax and the Timing of Deaths”) Andrew Chamberlain reviewed an article from Economists’ Voice by Australian researchers Joshua Gans and Andrew Leigh.

Rates of death plummeted in the final week of the tax and rose significantly in the first week without estate tax. Only nine percent of all estates paid estate taxes but five percent of all estates which faced estate tax managed to avoid it.

“Over half of those who would have paid the estate tax in its last week of operation manage to avoid doing so,” concluded the researchers.

This illustration is not simply cited as a preview of what to expect around late December of 2009 prior to the arrival of estate tax repeal, but rather as a predictor of human behavior in general. We'll assume that the stepped-up basis will remain but that with capital gains taking on greater priority as a tax liability for planning purposes in general, property owners will actively seek lifetime transfers that preserve the benefits of the stepped-up basis.

Selling A Series of Homes

Taxpayers who own homes have a specific exemption of $250,000 for an individual ($500,000 for a married couple) for gains on a primary residence in which the taxpayers resided for two of the previous five years.

This rule may not help owners of non-residential properties, but for those taxpayers who own multiple properties that can qualify as a home, the homeowner’s exemption to capital gains can be utilized as a renewable resource. By establishing residency in a succession of homes, multiple properties can qualify under the exemption and pass without capital gains.

For investors, no such exemption is applicable and the sale of investment realty results in a capital gain. That liability may be 15% or 20% depending on the income tax

bracket of the taxpayer or the rate schedule applicable at the time of the transfer. Even where the capital gain might have been 15%, the calculation of alternate minimum tax may well push the effective tax hit up to 20%.

The 1031 Exchange

Under section 1031 of the Internal Revenue Code, an investor may exchange investment realty of similar values without incurring a capital gain. The gain is simply deferred. As a result, the investor can divest unwanted property, obtain newly desired property, pay no capital gain now, and possibly have the new property pass through an estate at death with a stepped up basis.

The reasoning is simple: There is a like-kind exchange so that the owner is left in the same situation with respect to capital gains, no better and no worse. The investor's property has the same value before and after the exchange, so the basis remains unchanged, no gain is realized, and no tax is paid currently. To the extent that the exchange of properties is not exactly the same value, the excess can be taxed as a sale or a purchase.

Alas, the elegantly simple logic of this exchange did not inspire an equally succinct set of rules from the Treasury Department for implementing 1031 exchanges. Consider the critical requirements that apply and the potential pitfalls that could unintentionally cause the exchange of $50 million properties to generate millions of capital gains tax liability to both parties.

First, only the same type of property can be exchanged. Note: Only realty can be exchanged. Shares of an LLC are considered personalty and do not qualify, per se. This is a significant since LLCs have become extremely prevalent as a form of holding each real estate property. There are ways to address this.

Second, there are strict time limits involved. Replacement property must be identified within 45 days and the exchange must be made within 180 days.

Third, a qualified intermediary is employed to address all the compliance issues involved.

As a practical matter, compliance is a specialty involving professionals so the size of the transaction and the savings involved must be large enough to justify utilizing section 1031.

Convenient Twists

Finding another suitable property, matching the values, and taking on significant new management issues for a new property may not be suitable for all investors. Conveniently, an owner can make an exchange for a number of shares in a tenancy in common (TIC).

Tenancies in common are so basic, so standard, that one would never suspect them to play a role in a sophisticated capital gains maneuver. Essentially, these tenancies are set up as pooled assets that enable owners of smaller properties to take advantage of economies of scale by acting collectively.

Another alternative is the umbrella partnership real estate investment trust (UPREIT). This involves the use of a realty operating partnership. Property owners sell their shares to the partnership in return for shares under section 721. Owners of properties held by an LLC may pursue this alternative rather than converting to a conventional corporate entity.

Possible, Plausible, Probable

We have not yet reached the abyss of actual repeal in 2010 but if it seems like we've been running in slow motion toward repeal for the better part of a decade…it is because that's what has taken place.

Going forward with any of the current scenarios that are likely, most taxpayers will not face a Federal estate tax even if there is no repeal. In 2001, there were 73,736 estate tax returns filed for estates under $1.5 million. In 2006, there were 2,009 estate tax returns for estates of that size. Large estate tax exemptions phased in and more estates were not only beyond taxation but also beyond needing to file returns.

Expressed as a percentage of all adult deaths, estates with taxable returns ranged from .88% to 2.02% between 1934 and 1954 but then began steadily increasing and peaked at 7.65% in 1976. Tax reforms have, for the most part, suppressed the level to 2% or less since that time. In 2004, there were 2,344,354 deaths and only 19,294 or .82% that were taxable.

Writing for the Center on Budget and Policy Priorities ("The State of the Estate Tax as of 2006"), authors Joel Friedman and Aviva Aron-Dine analyzed data from the IRS and the Brookings Tax Policy Center to project that with the advent of the $2 million estate tax exemption in 2006 the percentage of taxable estates would drop to .5% and that with a $3.5 million exemption in 2009, the percentage would fall to .3%.

Either the tax will be repealed or there will be a large enough exemption, perhaps $3.5 million, perhaps $5 million, or perhaps some other substantial amount that in all likelihood will allow for doubling in its effectiveness by spouses each using their own exemption to pass a marital estate to the next generation, as well as cost-of-living adjustments.

Annual or periodic adjustments of exemption amounts may not seem relevant now, and may not change the overall exemption significantly in terms of the overall percentage of American estates that have any Federal estate tax liability whatsoever, but in this context, COLAs are a sleeping giant.

The true significance of a cost-of-living adjustment is that the estate tax may enter a period of stability. When Congress has failed to follow through on repeal, recognizes the futility of the effort, and puts the estate tax on automatic pilot, increasing very slowly over the next 25 years, it may very well ensure that Congress does not return to this subject for a generation. This is benign neglect that will benefit planning.

Post Repeal Planning

lt would be an understatement to note that post-repeal estate planning has some open-ended questions, but one thing the Australian example plainly illustrates is that

taxpayers confronted by a tax liability will find any which way to avoid it, even if it means altering official dates of death.

Such events should be great news for estate planners. Brethren of our estate planning fraternity of disciplines covering the respective arts of law, accounting, insurance, investing, and financial planning can finally engage in some meaningful long-term planning…except for the fact that the most significant of planning topics, the federal estate tax, will continue to be a non-issue for the vast majority of estates.

Planning will likely focus on several other remaining threats such as capital gains. State-level estate taxes become a significant planning concern as one of the biggest tax hits some estates will face.

Celebrity Estates

The Trusts of Crocodile Dundee

Once he was best know in the United States as the spokesman for Australian tourism and an advertisement in which he famously said, “throw another shrimp on the barbie,” but after Paul Hogan appeared in the internationally popular 1986 file, Crocodile Dundee," he would be a celebrity.

Hogan went on to appear in follow-up flics as "Crocodile Dundee II" (1988), "Crocodile Dundee in Los Angeles" (2001), not to mention "Flipper," "Almost an Angel," and "Lightning Jack."

These cinematic treasures sufficed to establish an estate that apparently has led to mansions held in a trust for which Hogan's attorney and another advisor are trustees.

The trust purchased a five-bedroom ocean front home in Santa Barbara for $7.1 million in November 2005 and then sold it for $9.6 million in April 2008. That's 14% annual appreciation. Hogan and/or his trusts also may own properties in Beverly Hills and Colorado.

The trust has kept a low profile until now but news about the mansion sale may have attracted the attention of the Australian Crime Commission which is now investigating the failure to pay taxes. Nothing has been proven, however, and it is not clear if wealth was channeled to the trust in a manner that satisfies Australian law or if tax liabilities apply.

Australia abolished its estate tax in 1979 but there are various other taxes that apply to the wealthy in general. Australia has taken a holistic approach to the super wealthy by identifying the 1,200 persons who own or control assets of $30 million or more and then supervising the overall level of tax payments from them.

Considering that trusts are supposed to be private, the unrelenting scrutiny on celebrities has revealed several cleverly named celebrity trusts in use. For example, Batman star Heath Ledger placed two mansions in a trust called "Thank You For The Trust," and Angelina Jolie and Brad Pitt used their Mondo Bongo Trust to purchase a $3.5 million home in the French quarter of New Orleans. At least the trust terms remain private.