

The Biggest (Tax) Loser: Misguided Gifts of Real Estate

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First the good news: with the increase of the federal estate tax exemption to \$5,430,000 in 2015, most taxpayers no longer need to be concerned about federal estate taxes. However, the increased estate tax exemption has had no effect on the income and property tax implications associated with asset transfers.

Consider this common scenario: an elderly widower ("Dad") wants to avoid probate. To do this, he makes a lifetime transfer of his home, and the surrounding orchard, to his only son ("Son"). Perhaps Dad even made the transfer at the recommendation of his realtor or financial adviser. To save on fees, Dad calls the local tax assessor's office for help. The clerk provides Dad a list of document preparation paralegals. Dad asks one such paralegal to draft deeds to transfer the properties. Dad signs the deeds and has them recorded. Dad is relieved and believes he has made things easier for Son. Although well-meaning, this strategy can have disastrous income tax results for Son, as you will soon see.

Capital Gain Tax Overview

The income tax implications of the above transfer center on the capital gains tax due on the sale of appreciated property. "Capital Gain" is the difference between an owner's basis in a property, and the price at which that property is sold. When a person sells property and has capital gain, they generally have to pay Federal and State income taxes on that gain (although there are a few exceptions). The rules used to compute a beneficiary's capital gains tax basis differ depending on how the property was received, simplified as follows:

- **Basis of Lifetime Gifts:** Lifetime gift recipients take "carryover basis" in the property received. Carryover basis is equal to (1) the purchase price the transferor paid for the asset, plus (2) the cost of improvements made to the property, (3) minus depreciation taken on the property.
- **Basis of Gifts at Death:** Beneficiaries who receive assets at the transferor's death take "stepped-up basis" in the property received. Stepped-up basis is equal to the fair market value (FMV) of the property on the date of the transferor's death.

Overview Applied

Now that we understand the basics of basis, let's return to our hypothetical.

Dad bought this house for \$17,000 in 1970 and over the years made improvements totaling \$23,000. His adjusted basis in the house is \$40,000. In 1985 Dad bought the adjacent walnut orchard, a 20 acre parcel. Dad has fully depreciated the orchard and has zero basis. The house's FMV at the time of Dad's transfer to Son is \$540,000. The orchard's FMV is \$800,000. The following two scenarios better illustrate the tax difference between a lifetime gift and a gift at death:

Lifetime Gift to Avoid Probate: Dad makes a lifetime transfer of his house and the orchard to Son (as described above).

- This was a lifetime gift. Son takes carryover basis in both properties. \$40,000 basis in the house and \$0 basis in the orchard. Son sells the house for \$540,000. He has a capital gain of \$500,000 which his CPA says will cost him \$185,000 in capital gains taxes. [$\$119,000 (23.8\% \times \$500,000)$ in Federal income taxes and $\$66,500 (13.3\% \times \$500,000)$ in California income taxes]. Son wanted to sell the orchard as well, but can't stomach the \$296,800 ($37.1\% \times \$800,000$) in capital gains taxes he would incur. Instead, Son uses the after tax income from the orchard to support Dad in his final years.

Revocable Trust to Avoid Probate-Transfer at Death: Dad consults with his estate planning attorney who drafts a revocable trust that transfers his house and orchard to Son at death.

- This was a transfer at death. Son takes stepped-up basis in both properties. \$540,000 basis in the house and \$800,000 basis in the orchard. Son sells the house and has zero capital gain ($\$540,000$ sale price less $\$540,000$ basis = 0). Son then a) immediately sells the orchard for zero capital gain, or b) keeps the producing orchard and depreciates the trees over 25 years, substantially reducing his income tax burden well into the future.

Result

Stepped-up basis offers two important advantages: (1) The increase in basis to FMV avoids any capital gain taxes on an immediate sale of the property and minimizes capital gains on a future sale of the property. (2) For income-producing property, the step-up in basis also resets the depreciation clock, resulting in years of significant income tax savings.

Caveats

1. Lifetime gifts make sense in certain situations. Particularly for estates likely to incur estate taxes, in which case gifts of rapidly appreciating assets or fractional interests in entities or real property may be necessary to minimize future estate taxes, or in cases of Medi-Cal planning. Such considerations should be explored with an estate planning attorneys specializing in these areas.
2. Small factual changes often have a large tax implications. If Son takes carryover basis but stays in the house long enough to qualify it as his primary residence and meets all other statutory requirements for exclusion, he may then exclude \$250,000 of the capital gain on the sale (\$500,000 if he is married). If Son owns the house at death, his heirs are entitled to a step-up in basis. If Son converts the house to a rental property and then later sells this property as part of a Section 1031 like-kind exchange, he can defer the gain. If Son dies owning the 1031 property, *that* property gets a basis step-up at his death.
3. This discussion ignores property tax reassessment issues that are present for transfers between other than a parent and child, and also ignores the gift tax implications of lifetime transfers.

Bottom Line

Transferring assets solely to avoid probate can result in a tax disaster for your family. Each taxpayer's particular situation is unique and should be reviewed with an estate planning attorney, CPA, and financial advisor to develop a workable, comprehensive, and integrated estate and income tax plan that allows you to minimize taxes while accomplishing your financial and estate planning goals.

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