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Post Tax Reform Estate Planning Issues with Like Kind Exchanges:

Re-examining the “Hold Until Death” Rule and Opportunity Zones

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The Interplay of Estate Tax Issues and Real Estate Transaction Planning Generally

Disclaimer: Today, we're talking federal taxes ONLY – Individual state estate and inheritance tax issues are separate

Overview: When working on real estate issues with older individuals, must keep in mind the interaction of THREE key factors:

1. The Estate Tax Exemption Amounts
2. The Rate Differential between Estate Tax and Capital Gains Tax
3. The Stepped-Up Basis Rule

An Analytic Matrix

Assume: Couple has $11.2 million x 2 ($22.4M) in 2018 Exemption

	Sell Now	Hold to Death
Above Exemption	Capital Gains plus Estate Tax on Remainder	Estate Tax Only on FMV
Below Exemption	Capital Gains	ZERO due to Stepped-Up Basis

1. The Effect of the Exemption Rules (Generally, Sections 2001, 2010 of the IRC, 26 U.S.C. § 2001, 2010)

- Individual exemption: $11.2 million
- Married Couple: $22.4 million
- Portable between them:

Example: Dad dies and leaves $5 million to the kids, everything else to Mom. Mom can leave $17.4 million to the kids.

Key Takeaway: There is NO FEDERAL ESTATE TAX unless the individual/couple have more than $11.2/$22.4M at death (using 2018 exemption amount rounded)

2. The Rate Differential

Capital Gains Rate: Generally, 20%

Estate Tax Rate: graduated but top rate is 40%

If an older person who is ABOVE the Exemption Amount sells an asset while living, they pay BOTH taxes!

Example:

- Dad bought a shopping center for $1 million;
- It's now worth $5 million. Basis is $1 million;
- If Dad sells, Capital Gains Tax is 20% of $4 million Gain, or $800,000.
- If Dad and Mom are above the Exemption Amount, tax on remaining $4.2 million is $1.680 million if all $4.2 million is above the exemption. Total tax hit is $2.48 million.

NOTE: If Dad had held the property until death, it would have been taxed in his estate at 40% x $5 million, or $2.0 million. Selling during Dad's lifetime cost the estate $480k in extra taxes.

3. The Stepped-Up Basis Rule
(Generally, Section 1014, of the IRC 26 U.S.C. § 1014)

Generally, if an asset is included in the Gross Estate at FMV, then the heirs get to claim that FMV as their taxable basis for calculating Capital Gains tax when they sell.

Example (same facts as above):

- Dad bought a shopping center for $1 million;
- It's now worth $5 million. Basis is $1 million;
- If Dad sells, Capital Gains Tax is 20% of $4 million gain, or $800,000.
- If Dad holds until death:

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Key Question: Are Mom and Dad above $22.4 million Taxable Estate?

YES:

- Total Estate Tax hit is 40% of $5 million, Estate pays $2 million
- Heirs' basis is NOW $5 million, their Capital Gain on Sale at $5 million is ZERO

NO:

- Total Estate tax is ZERO
- Heirs pay ZERO capital gains tax, due to Stepped-Up Basis

General Conclusion: Whether Dad is above or below the Exemption Amount, it is always CHEAPER for combined tax impact to HOLD appreciated real estate until death.

BUT: Taxes are a major factor, but not the ONLY factor in planning. More to come on this.

II. Like-kind Exchanges (LKE's) and Estate Planning

Overview: If the client's primary goal is to avoid taxes, LKE's are a valuable tool because they can facilitate the "Hold Until Death" Strategy.

1. Overview of LKE's under Section 1031 of IRC
   A. No Capital Gains Tax if taxpayer merely exchanges one real estate holding for another
   B. Broad definition of "Like-Kind" – e.g. industrial for apartments or shopping center;

NOTE: Ideal in situations where a taxpayer owns real estate in connection with his business, such as an industrial or retail property, and now wants to sell the business

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Overview (cont'd.)

C. Basis in current property carries over to new property (thereby deferring the capital gain, and as shown above, the heirs get an INCREASE in the basis to FMV at date of death)

D. Flexibility in timing: through various "Qualified Intermediary" procedures, the taxpayer can:

Sell Now, Buy Later (6 months limit) (the so-called "Starker" deal)

Sell Now, Buy Later and Build Improvements with the proceeds (6 months!!)

Buy Now, Sell Later (It's tricky—have to borrow to do the buy)

Buy Now and Build Improvements, Sell Later (borrow more for the improvements)

Overview (cont'd.)

E. Taxable "Boot" issues

If Sale Price is greater than Buy Price, Excess is taxable as "Boot"

Mortgages can greatly complicate the Boot Analysis (Beyond our scope!)

2. Estate Planning Aspects

A. Benefits in addition to tax avoidance:

1) Depending on what is bought, can provide stable rental income stream

   Example: Dad owns industrial building that housed his Widget Manufacturing business; he can sell the business to another company that doesn’t want the real estate, and sell the real estate to some other user which is not necessarily a strong credit, and use the proceeds to buy a Walgreen’s store at an effective 6% rate of return.

Benefits (cont'd.)

2) Depending on Dad's overall portfolio, can provide diversification by including a core real estate holding
3) Depending on what is bought, can be relatively management-free, such as a Walgreen's store

B. Be Careful What You Wish For! There are COMPLICATIONS for Dad:

1) Today's Credity Worthy Tenant is Tomorrow's Bankruptcy Filing:

   Sears; Toys R Us; Phar-More; A&P Stores; Dominick's; and Eastman Kodak.

2) Cap Rates are HISTORICALLY LOW, which means that Prices are at an ALL TIME HIGH.

   Example of Cap Rate (read: interest rates) Risk:

   Walgreen's is paying $60,000 in net rent; value at 6% Cap is $1 million

   If Cap Rates go to 8%, value drops to $750,000

   Might have been better off to pay the capital gains tax and hold cash!

Complications (cont'd.)

3) Time erodes the remaining Lease Term!

   Properties are routinely being marketed with 15 years or less left on the term

   What happens if Walgreen's doesn't renew? Especially if the Walgreen's is in a secondary or tertiary market?

Complications (cont'd.)

4) Implications for the Heirs and the Trustee/Executor

- What about MOM?? She may need cash for health care and living expenses beyond the estate's income--but the real estate is difficult to liquify, and partial liquidations are very difficult
- Siblings may have differing views of selling vs. continuing to hold, Opportunity for post-death squabbling
- If they hold, who's going to manage the property?
- What are the other assets in the estate? Diversification?

Conclusion: Don't let the real estate brokers convince Dad to do a LKE without a thorough discussion of the potential complications. In certain cases, particularly when the total estate is BELOW the Exemption amount, and depending on the amount of the potential capital gain, it may be better to sell the property outright, pay the capital gains tax, and obtain the benefits of full liquidity and the ability to invest in a diversified portfolio.

Opportunity Zones:

A 1031 Game Changer:

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2017 Tax Cuts and Jobs Act:

Can Defer Capital Gains Tax on sale of <u>stock</u>, <u>business assets</u> and real estate by reinvesting in a "Qualified Opportunity Zone Fund" IRC§1400Z-2(d)(1)

<u>Important</u>: not just real estate!

Compare to §1031: Real Estate <u>Only</u>

Ann Arbor / Chicago / Cincinnati / Cleveland / Columbus / Dayton / Indianapolis / Northern Kentucky / Phoenix

Opportunity Zones have been designated in all 50 states, Puerto Rico and U.S. Territories

Important: An investment in O-Zone allows reinvestment of the gain only, whereas §1031 requires reinvestment plus gain (partial reinvestment results in allocation of gain to cash not reinvested). Additional amounts invested in O-Zone will be entitled to NO special tax benefits.

Example:

Basis: = 100

Value: = 300

Gain: = 200

- Under 1031: Reinvest only 200,
  Capital Gain = 66.6, Tax at 20% = 13.2
- Under O-Zone: Reinvest only 200,
  Capital Gain = 0, 100 distributed
  Tax Free

Important:

Deferred Gain is Taxed on earlier of sale or Dec. 31, 2026

But: 10% of Gain eliminated if held 5 years, and 15% of gain eliminated if held 7 years; i.e., 15% of Gain is permanently eliminated from tax

And: If held longer than ten years, no tax on increase in value above original reinvested amount.

Example:

Basis = 100

Value = 300

Gain = 200

1) O-Zone Reinvestment Before 12/31/19 of 200

Result: No Tax Due on 200

2) On December 31, 2026:

85% of Original 200 Gain is Realized;

20% Tax Due on 170, or 34

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Opportunity Zones: (cont'd.)

3) Assume sale after 12/31/29 at 350

Basis = 200

Gain = 150

No Tax Due on entire Gain of 150

Observe: Total Gain is 200 Original + 150 in O-Zone

Total tax on 350 of gain is only 34, a substantial reduction of effective capital gains rate

It's only the first inning:

Many open issues,

More Regs to be forthcoming

But:

An Important Planning Opportunity

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