

NATIONAL ASSOCIATION OF REALTORS®

EYE ON THE HILL

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COPING WITH UNCERTAINTY – THE ESTATE TAX

When President Bush's 2001 tax cuts – including the estate tax modifications -- were enacted, they were subject to arcane budget rules that allowed the cuts to be in effect for only 10 years. Thus, all of the 2001 tax cuts (and the 2003 capital gains tax reduction) will, absent new legislation, expire as of December 31, 2010. We then revert to pre-2001 law. Because the estate tax was phased-down between 2001 and 2009, "repeal" will actually be in effect for only one year: 2010.

So Will Congress Make Repeal Permanent? Since 2003, tax cut advocates have sought but failed to make any of the 2001 tax cuts permanent. In 2003 and 2005, the House passed legislation to make the estate tax repeal permanent, but the Senate has consistently fallen short of the required votes. Just this June, the Senate again failed to pass permanent repeal. The House responded to the Senate impasse by approving, on a bipartisan basis, an estate tax bill (HR 5638) that would retain the estate tax, but reduce its burdens.

The Senate has not yet scheduled a vote on H.R.5638. Majority Leader Frist (R-TN) has indicated that a vote will not be scheduled until it is clear that the bill (or an agreed upon substitute) can pass on a bipartisan basis. Such a vote is unlikely to occur this summer.

How Should REALTORS® Evaluate a One-year Estate Tax Repeal? Planning for family wealth transfers and business succession in the current unsettled estate tax context is difficult at best. One critical feature of estate tax repeal – the determination of an asset's "basis" or value in the estate -- is critically important for business owners and real estate investors and should weigh heavily in determining the "best" resolution of this debate.

For some, repeal might be less valuable than it sounds. The reason? In 2010, the year of repeal, there is no tax on the estate itself, but the value of assets in the hands of the heirs will be determined under rules that are significantly different from longstanding estate tax law. An asset's value in the hands of the heir will affect the heir's capital gains liability if/when the heir sells the asset. The formal name for the anticipated 2010 change is "carryover basis," in contrast to the current "stepped-up basis" rules. A somewhat over-simplified example explains the difference and why it matters.

Assume that your client inherited an asset from Aunt Sally at her death last year. *Under current law*, the asset's value in your client's hands is the same as its *fair market value* the day Aunt Sally died. Say that's \$600,000. If your client were to sell the asset for \$700,000, the capital gain would be \$100,000 (\$700,000 less \$600,000). In 2006, the capital gains tax would be \$15,000 (\$100,000 x 15%).

Next, assume the same facts, but *the repeal rules apply*. Again, your client has inherited Aunt Sally's property and it has a fair market value of \$600,000. Under the *repeal* regime, the value of that asset in your client's hands is required to be *the same as its value when Aunt Sally acquired it*. Say Aunt Sally bought the property for \$200,000. Its value to your client, as the heir, is therefore \$200,000. Again assume your client can sell the property for \$700,000. The capital gain on that transaction would be \$500,000. This year that tax liability would be \$75,000 (\$500,000 x 15%).

So, under current law, the "basis" of an inherited asset (the capital invested in it) is "stepped up" to its fair market value. Under *repeal*, the "basis" is "carried over" from the decedent to the heir. Thus, under carryover basis/repeal, there is no tax – either capital gains or estate – on any appreciation in the value of Aunt Sally's property. If the inherited asset is later sold, carryover basis requires that the gain (both the gain that wasn't taxed at Aunt Sally's death plus any additional appreciation) be taxed at the time of sale. Today, Aunt Sally's appreciation is taxed in the estate and then given a fresh start in the hands of the heirs by means of stepped-up basis.

So How Does the House Compromise Work? H.R. 5638 would keep the estate tax alive and *would retain the stepped-up basis rules*. The bill would significantly reduce the number of individuals who would have an estate tax liability. Even today, very few individuals pay – or even file a return for – the estate tax. Under H.R. 5638, the number of estate tax payers would decrease even further. The following chart shows three fundamental elements of the tax: treatment of the basis, the rate and the amount excluded from tax under current law and under H.R. 5638. The H.R. 5638 changes commence in 2010 and after (shaded boxes).

FEATURE	2006	2007	2008	2009	2010	2011 and After
Current Law: Excluded Amount (\$\$ Millions)	\$2.0	\$2.0	\$2.0	\$3.5	All (Repeal)	\$1.0
Excluded Amount After HR 5638 (\$\$ Millions)	\$2.0	\$2.0	\$2.0	\$3.5	\$5.0	\$5.0
Current Law: Maximum Rate	46%	45%	45%	45%	None	55%
Maximum Rate After HR 5638	46%	45%	45%	45%	30%	40%
Current Law: Basis	Stepped-up	Stepped-up	Stepped-up	Stepped-up	Carry Over	Stepped up
Basis – After HR 5638	Stepped-up	Stepped-up	Stepped-up	Stepped-up	Stepped-up	Stepped-up

Where's NAR? NAR has consistently supported efforts to repeal the estate tax. That said, however, NAR's Federal Taxation Committee has held deep reservations about a repeal system that would replace stepped-up basis with carryover basis. Accordingly, NAR's Board of Directors adopted new policy guidelines at its 2006 Midyear Meeting. Those guidelines note that a primary goal in the estate tax debate is to retain stepped-up basis rules. The NAR policy guidelines also support a \$5 million exclusion and recommend that estate tax rates be pegged to capital gains rates or individual tax rates. Accordingly, NAR supported House passage of HR 5638 and will continue to press the Senate to adopt that bill or a similar compromise.