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Smoke, Mirrors and Effective Dates
—New Tax Law Has Significant Impact on Real Estate

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One aspect of the new tax law impacts real estate more profoundly than any other sector of the economy. So, if you are a real estate owner, should you be cheering? Well, that depends on your particular situation. On June 7, 2001, amid much fanfare, President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"). The most radical change enacted was the repeal of the estate tax.

Under current law, property included in a decedent's estate for estate tax purposes receives a fair market value basis for income tax purposes in the hands of the heirs, such that a sale of the property at its estate tax value results in no gain or loss. Part of the revenue trade-off for the repeal of the estate tax is that this unlimited "step-up" in basis at death is also repealed, effective with repeal of the estate tax. The general regime of basis being marked-to-market is replaced with a "carryover basis" rule. Nevertheless, a limited basis step-up of $1.3 million still would be allowed, with an additional $3 million of basis increase allowed for property passing either outright to a surviving spouse or to a so-called QTIP trust for his or her benefit. The executor of the decedent's estate is given the discretion to allocate the basis increase among the decedent's assets.

Trading the estate tax for the basis step-up does not necessarily benefit all estates. Take these two examples: Taxpayer A dies owning property worth $100,000,000, subject to $99,000,000 of debt, with a basis of zero. Taxpayer B dies owning a building worth $100,000,000, free and clear, with a basis of $100,000,000. Under the Act, taxpayer A's estate may not benefit from the repeal of the estate tax, since taxpayer A's building has a low net value, yet taxpayer A's heirs will be denied almost all of the $100,000,000 basis step-up which they would have had under prior law. In contrast, taxpayer B's estate may save as much as $55,000,000 in estate tax and is unaffected by the step-up at death limitation, since taxpayer B's basis in his property was already equal to its fair market value.

The highest estate tax rate is greater than the highest income tax rate, but since these rates are applied to different bases, an objective evaluation of the tradeoff from the vantage of all taxpayers is impossible. However, as we see from these examples, the income tax cost of losing the step-up will not necessarily bear any relationship to the savings from repeal of the estate tax, and this legislative trade off seems to benefit nearly all estates with greater net worth while hurting a significant number of estates with lesser net worth.

This aspect of the new legislation is most important for real estate, where, as in Taxpayer A's situation, debt far in excess of basis is commonly found. (In fact, practicing lawyers are most surprised when this is not the case.)

That is how the analysis would run if Congress simply made these two changes to the Internal Revenue Code. No portion of the Act, however, can be analyzed without considering several important provisions dealing with effective dates. First, the repeal of the estate tax does not take effect until 2010. This distant effective date casts serious doubt on the likelihood of the repeal ever going into effect. But wait! There's more!

One of the subterfuges buried in the Act concerns the changes to the credit for state death taxes. Under current law, a credit against the federal estate tax is allowed for death taxes paid to one or more states. The maximum allowable credit reaches 16 percent for each dollar of the taxable estate in excess of $10,100,000. The effect of these provisions is that a death tax imposed by a state that does not exceed the allowable federal credit results in no net cost to a decedent's estate. Instead of paying 55 percent to the federal government, an estate pays up to 16 percent to the state and the balance (for a total of 55 percent) to the federal government. Most states, including New York, impose a death tax that is equal to the maximum allowable federal credit for state death taxes, and thereby collect significant tax revenue, which may be said to come from the federal government, but which also might be described as a revenue-sharing arrangement between the federal government and the States.

Under the Act, the federal estate tax rates are lowered prior to repeal, with the maximum rates as follows:

2002	**50 %**
2003	**49 %**
2004	**48 %**
2005	**47 %**
2006	**46 %**
2007 - 2009	**45 %**

The Act phases out the allowable credit for state death taxes, but the phase out is not in proportion to reductions in the estate tax rate. Rather, for decedent's dying in 2002, the allowable credit is 75 percent of the credit that would be allowable under existing law; in 2003, it's 50 percent; and in 2004, it's 25 percent of the currently allowable credit. In 2005 (and thereafter), the credit is eliminated, but a deduction is allowed instead for any state death taxes paid. The result of all of this is that the federal government, while reducing the maximum federal estate tax rate for the benefit of taxpayers, will nevertheless collect more money at the margin than it was collecting before, with the burden of rate reductions being borne entirely by the states. It remains to be seen what action the states might take to preserve their revenue stream.

This heedless and disingenuous tinkering with the state death tax credit has particularly dangerous ramifications for New York taxpayers. For New York constitutional reasons, New York's tax provisions do not automatically conform to changes to the federal tax law; separate and specific New York legislative action is required. New York now imposes a state death tax equal to the maximum allowable federal credit for state death taxes based upon the federal tax code as in effect on July 22, 1998. If New York were not to modify its death tax, it would continue to impose a state death tax of up to 16 percent, even though the allowable federal credit is reduced or entirely eliminated. New York officials have been informed of this problem and are reportedly in favor of seeking legislation to ensure that the New York death tax does not result in any net cost to New York decedents. Clearly, however, in some way the revenue lost by New York state will hurt New York taxpayers, whether it takes the form of increased estate tax, increases in other taxes or budget cuts.

It seems clear that in a world with no federal estate tax, there can be no state death tax credit. However, by eliminating the state death tax credit more rapidly than the federal estate tax rates are reduced, the legislation may increase the combined federal and state estate tax bills for certain taxpayers, as well as wreak havoc with state budgets.

But here comes the zinger! You were thinking, maybe the phase-out period is a little bumpy, but at the end of the road, no estate tax! Maybe that will actually happen; maybe 2010 comes and the estate tax goes away. Then it comes back again in 2011, exactly the way it exists today. All that transition cost and complexity for nothing. And, in the short term, the states will bear the cost of an estate tax repeal that has a life of one year.

Needless to say, none of the legislators actually plan on an estate tax repeal in 2010 followed by reinstatement in 2011. The Act sunsets because, without a sunset provision, a Senate parliamentary rule effectively would have required sixty votes to pass the legislation. This parliamentary rule (informally called the "Byrd rule") applies whenever tax legislation has a negative revenue effect beyond the ten-year budget projection period and, without the sunset provision, the Act would have had such a negative revenue effect. Thus, only by providing for a sunset could the legislation pass the Senate. Next year, the Senate could vote to push back the effective date of the sunset provisions from December 31, 2010 to December 31, 2011, and such a vote would not require 60 votes. Yet, Congress could also repeal the repeal before it ever goes into effect. Taxpayers are now utterly unable to plan for the future. The only group benefited by this chaos are trusts and estates lawyers, who now must revise nearly every will and many trusts.

We are now at the point where one cannot meaningfully read the Internal Revenue Code without knowing the results of the next Congressional election. The Code has been transformed from a document setting forth concrete rules to a series of alternate realities, held together with effective dates, sunset provisions and political prognostication. After years of "tax simplification acts" that did not simplify, Congress treats us to repeal that does not repeal.