STEPPED-UP BASIS &TAXATION OF UNREALIZED CAPITAL GAINS

NMHC/NAA Viewpoint

The Biden Administration's proposal to tax certain unrealized capital gains at death could diminish or discourage the ability of heirs to make improvements to inherited property, including affordable housing, or to make other productive investments.

Given that many apartment firms are small businesses, often family owned, the transfer of assets to heirs is a major consideration for company principals. While the estate tax may apply to decedents if exemption amounts are exceeded, current law appropriately enables those inheriting property to step-up the basis of that property to fair market value at the time of transfer. This is particularly important for the apartment industry because many industry executives' estates include significant amounts of depreciable real property.

To illustrate how present tax law works, consider the following example: A couple purchased an apartment property in 1995 for $7.5 million before passing away in 2023 and transferring the property to an heir. At the time of transfer, the property is worth $22.5 million and, due to depreciation of $9 million and improvements of $3 million, has a tax basis of $1.5 million. The property has an operating income of $1.575 million.

Currently, the $1.5 million in tax basis would be stepped-up to $22.5 million. Tax would only be imposed when the heir sells the asset and would be based on the difference between the value of the property at time of sale and the $22.5 million in tax basis (and any changes thereto).

Unfortunately, the Biden Administration is proposing to impose tax on gain exceeding a threshold amount (e.g., $10.5 million) at the time of transfer. In the example, above, a capital gain of $10.5 million would be realized when the property is passed to an heir. (This is calculated as $22.5 million in fair market value, less $1.5 million in basis, and less a $10.5 million exclusion.) The $10.5 million capital gain would generate a $2.55 million tax liability under current-law rates. This would far exceed the building's annual operating income. Notably, if other Biden Administration proposals were simultaneously enacted, including those increasing capital gains tax rates, imposing and raising net investment income taxes on active capital gains, and taxing depreciation recapture at ordinary income tax rates, the tax on such a sale would be far higher.

The Biden Administration is seeking to effectively make death a taxable event at a level that is less than half of today's estate exemption.

If enacted, this proposal would have extremely unfortunate consequences. Not only would death become a taxable event at $10.5 million for couples, a level far below today's estate tax exclusion of $25.84 million for couples, but funds necessary to pay the tax could be deferred from beneficial uses.

Under one option, taxpayers would have 15 years to pay the tax. However, this would mean that a substantial portion of a property's operating income (10.8 percent in the example above) would go just toward paying this tax, leaving less to improve and upgrade the property (in addition to paying current-year income and property taxes attributable to the asset). This could negatively impact the amount of affordable housing in the marketplace.

Under a second option, family-owned and operated businesses could defer tax until a property is sold. While tax may not be immediately due, the prospect of a significant tax bill upon sale (i.e., the deferred tax plus potential additional taxes incurred after transfer) could deter an heir from making a sale to invest in other assets or multiple heirs who may wish to start new ventures.