



Issue Fact Sheet

NMHC/NAA Joint Legislative Program • Suite 540 • 1850 M Street, NW • Washington, DC 20036 • (202) 974-2300 • Fax (202) 775-0112 • www.nmhc.org

ESTATE TAX

Background

After allowing the estate tax to lapse in 2010, in the final days of the 111th Congress, lawmakers passed a bill to reinstate the levy for 2011 and 2012 with an exemption level of \$5 million (indexed for inflation after 2011) and a top tax rate of 35 percent. Without further action, in 2013 the tax will in revert to a \$1 million exemption and a 55 percent rate. Because most members will find that unacceptable, there is continued pressure on Congress to enact long-term estate tax legislation.

There are three key elements to any estate tax proposal: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements are important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- **Exemption Levels:** The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. Exemption levels in 2011 and 2012 are \$5 million after being unlimited in 2010 (unless taxpayers elect to use the 2011 law-see below). They are currently scheduled to revert to \$1 million in 2013 and thereafter.
- **Tax Rates:** The estate tax rate is the tax rate that will apply to the amount of an estate that exceeds the exemption level. The maximum rate is 35 percent in 2011 and 2012 after being zero in 2010. The rate is scheduled to jump 55 percent (plus an additional five percent surtax applicable to some estates) in 2013 and thereafter.
- **Basis Rules:** The basis rules determine the tax basis of inherited property. There are generally two different types of basis rules—stepped-up basis and rollover basis. With a stepped-up basis, the tax basis of inherited property is reset to reflect the fair market value of the property at the time of the inheritance. By contrast, under rollover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor (i.e., the heir “steps into the shoes” of the donor with regard to tax basis). This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Stepped-up basis is the rule for all years except 2010 when the estate tax was repealed, (Notably, for 2010, taxpayers may elect to use 2011 estate tax rules and take advantage of stepped-up basis for inherited assets if they choose not to take advantage of full repeal that comes along with carried over basis.)

The Importance of Stepped-Up Basis

Retaining a stepped-up basis rule is critical for estates that contain significant amounts of depreciated real property. Under a roll-over basis rule, the tax basis of inherited property can be quite low if the property was purchased long ago and if it has been depreciated over a number of years. For estates containing commercial real estate, this scenario creates two major disadvantages when compared to a stepped-up basis system. First, if the heir sells the property, they will likely face higher capital gains taxes (including recapture taxes). Second, the heir will have a lower basis for purposes of determining any future tax depreciation deductions.

Repealing stepped-up basis not only harms heirs of commercial property, it can also have the unintended consequence of exacerbating the nation’s affordable housing shortage. Consider the not uncommon example of heirs who receive an apartment property that rents to low- and moderate-income households. The property has no basis and sizeable debt. If the heirs want to sell the property, they will face a depreciation recapture tax of 25 percent and a capital gains tax of 15 percent on any remaining gain, which is often more than the likely sales price of the property. Knowing that the property is likely worth less than the tax bill, the heirs will also be discouraged from investing further capital to maintain it. As a result, the property will remain “frozen” and may deteriorate to the point that it is lost to the affordable housing stock.

NMHC/NAA Position

In the interest of promoting certainty and stability in the tax code, NMHC urges Congress to swiftly enact permanent estate tax legislation that retains a stepped-up basis regime along with a \$5 million exemption and a 35 percent rate. We

also commend lawmakers for simplifying the law and enabling couples to more easily claim the entire \$10 million exemption. We encourage them to retain that improvement in any long-term legislation.

Relevant Committees

Senate Finance
House Ways and Means
Joint Committee on Taxation

Contact Information

Matthew Berger
Vice President of Tax
NMHC/NAA Joint Legislative Program
202/974-2362
mberger@nmhc.org

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