ESTATE PLANNING FOR THE COMMERCIAL BUILDING OWNER

by: Donald B. Tipping, II

Estate planning is the on going process of placing and owning your assets in the most tax advantageous method to minimize estate taxes and pass on to your heirs the maximum amount of assets with the least amount of taxes paid permissible by law.

Estate planning is that mysterious world occupied by attorneys and certified public accountants. Oftentimes, each is not sure of what the other should be doing and is, in fact, actually doing. That is most people’s common misconception. To some extent, it is true. However, with a little preparation and some forethought, anybody can learn to analyze their estate and its tax position at any given point in time.

Should I do any estate planning?

Yes, without a doubt. A building owner’s estate is generally comprised of apartments, buildings, a home, perhaps another rental residence, and some other investments. You may not consider yourself wealthy from a cash point of view, but you will possess an estate tax problem upon your death if you do not make plans today to preserve your estate for your heirs. Moreover, you often cannot afford to give away certain income producing assets to your children during your lifetime because you need that income to live on today. However there are certain entities that can be established to pass assets on to heirs while the creators maintain complete control.

What assets are subject to estate planning?

All assets in your name, your spouse’s name and in both of your names are subject to estate planning, and should be addressed and dealt with. I will address the two most common forms of ownership later.

Why is estate planning necessary?

Without proper estate planning, any estate with gross assets in the state of California in excess of $100,000, will be required to go through probate. Probate is a title clearing process that generally takes anywhere from 12 months to 24 months, or greater. Probate can also become extremely expensive and frustrating. Moreover, if one’s estate is greater than $1,500,000 through 2005 and that person is single, federal estate taxes could be due upon the death of that person.

How to avoid probate?

Avoiding probate can be accomplished by establishing a living trust. A trust is nothing more than a contract. If you are married, a trust is a contract between you and your spouse establishing a manager (trustee) for your assets, stating how your assets will be handled while you are both alive, and what will happen to those assets upon your deaths. A trust is just as effective for single persons as well as married couples.

A living trust is established while you are alive and you actually transfer virtually all of your assets from your individual names to your name or names as trustees of your own trust.

A Living trust is established to avoid probate as well as maintain complete privacy as to your assets and how they will be transferred after your death. Testamentary trusts are established at death; they spring out of your will and are through probate. The living trust is also revocable. This means that if you change your mind at any time while you are still alive, you can amend any portion of the trust at any time or even revoke the entire trust. Living trusts are also know as "A/B trusts," "grantor trusts," "marital and residuary trust," "inter vivos trusts," or "probate avoidance trusts."

Is it important how I hold title to my rental properties and my house?

It is critically important. Most people hold title to their house, apartments and building in joint tenancy. This is often not the best way to hold title. If you are married and live in a community property state (California is community property state) and own appreciated property, you should carefully examine how these assets are titled. Taking steps now for a simple change in title ownership will potentially allow for significant income and estate tax savings in the future.

Why is joint tenancy often not the best way to hold property?

First and foremost, joint tenancy does not avoid probate upon the death of the last owner. For example, if you and your spouse own your properties as community property by operation of law they are free of probate. However, when you spouse dies, (unless she has placed the property in tenancy with someone else) the property will be probated because there is not a surviving joint tenant. But more importantly, you have passed up the use of a $1,500,000 estate tax exemption. That is a tax savings of approximately $500,000. The annual estate exclusion will increase.

Additionally, another problem can be created when you die and your surviving spouse remarries, and wanting to avoid probate, makes her new spouse a joint tenant in the ownership of the properties that you once owned with her. If she then dies, the properties will go to her new spouse and not to your children of your first marriage as you may have intended. This is a tragedy.

Another variation of this scenario is the childless couple. Assume one spouse dies and all of the joint tenancy property goes to the surviving spouse. If the surviving spouse should die without a will, all of the property will go to her family. In other words, without proper planning and written documents, all of the property goes to the relatives of the last spouse to die, thereby cutting out all of the relatives of the first spouse to die.

The biggest and most tragic problem of joint tenancy is the income tax problem. At the death of one of the spouses, only one half of the property receives a step up in basis to fair market value. This can be dramatically shown in the following example.

Say two couples (George and Martha and Jack and Jill) buy virtually identical properties for the same purchase price at the same time. Bought in 1985 and purchased for $400,000 each, George and Martha held title as joint tenants, while Jack and Jill held title as community property. Both George and Jack die in 2004 when each building is appraised for $4,000,000.

Martha (as the surviving spouse) has a new basis of $2,200,000 (1/2 of $4,000,000 plus ½ of $400,000). In 2005, Martha sells the building for $4,100,000. Martha incurs a taxable gain of $1,900,000 (sales price of $4,100,000 less adjusted basis, ignoring depreciation, of $2,200,000).

Contrast this to Jack and Jill. When Jack died, Jill's basis in the property became $4,000,000 (one hundred percent step up in adjusted basis to the fair market value at the date of Jack's death). Jill also sold the property in 2005 for $4,100,000, incurring a capital gain of only $100,000 (sales price of $4,100,000 less adjusted basis, ignoring depreciation, of $4,000,000).

In this example, a simple change in how title was held permanently avoided a taxable gain of $1,800,000, and meant the difference of paying approximately $380,000 in income taxes versus only $20,000, a savings of $360,000.

George and Martha as a Joint Tenants:

	George	Martha	Total
Cost basis before death	$ 200,000	200,000	400,000
FMV at George's death	2,000,000	2,000,000	4,000,000
Adjusted basis after death	2,000,000	200,000	2,200,000

	Jack	Jill	Total
Cost of basis before death	$ 200,000	200,000	400,000
FMV at Jack's death	2,000,000	2,000,000	4,000,000
Adjusted basis after death	2,000,000	2,000,000	4,000,000

Summary comparison:

	George & Martha Joint Tenants	Jack & Jill Community Prop
Sales price	$4,100,000	$4,100,000
Adjusted basis	2,200,000	4,000,000
Capital Gain	1,900,000	100,000
Tax Rate @ 15%	$ 380,000	$ 20,000

What is community property?

Community property is defined as all property acquired by a husband and wife during their marriage while living in a community property state. Each spouse is considered as owning a fifty percent (50%) interest in all of the property. According to state law, unless the property can be identified as separate property (such as inherited property or gifted property or pre-marital assets which have been kept separate and not co-mingled with other community property assets), then property is presumed to be community property.

This article has only briefly scratched the surface of a thorough and comprehensive estate planning discussion. Each person is unique, and their wants and desires need to be explored thoroughly before they can begin the process of estate planning. But that process should begin now. To delay can be a fatal flaw for any estate. Moreover, this article has probably raised more questions than it has answered and that is precisely the purpose of this article. You should annually review your estate position and make any necessary changes that you require.

The author, Donald B. Tipping, II has been a practicing CPA in Santa Ana in Orange County, California for over 25 years. He also possesses a JD from Western State University, College of Law. His practice encompasses both closely-held companies, high net worth individuals and business owners, and has had significant experience in the areas of estate planning and property ownership. He can be reached at 714-564-7630.