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Real Estate Exchanges as an estate planning tool

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If a taxpayer decides to take advantage of the "The Best Kept Secret in Real Estate," known as a Real Estate Exchange, and holds the replacement property upon his or her death, the taxpayer's estate receives a stepped-up tax basis in the replacement property. As a result, all of the built-in gain carried to the replacement property, which was not recognized on the relinquished property, disappears upon the taxpayer's death. For estates not subject to the federal estate tax, an exchange is an ideal estate-planning tool because it allows the taxpayer to transfer the property to his or her heirs with no built-in gain.

A decedent's estate can currently be taxed at rates of up to approximately 50%. Current tax rate on ones gain (profit) from disposition, can be as high as 32% which is a combination of depreciation recapture rate of 25% Federal and 9% for New York State. As a result, the taxpayer may be better off from a combined estate tax & income tax liability position to gift the relinquished or replacement property to his or her heirs prior to death. The donees will take a carryover basis from the donor, and therefore the built-in gain will remain; however, the post gift appreciation will be removed from the estate.

If a taxpayer or his or her heirs wishes to exchange property prior to or after a gift, the exchanging party should be sure that the exchange and the gift are separated by a lengthy period of time. The exchange and/or gift and the exchange was not intended at the time of the gift, or vice versa.

The taxpayer with a larger estate may also weigh the income tax savings from an exchange against the estate's need for liquidity to pay estate taxes upon the taxpayer's death. This need for liquidity could result in an unfavorable forced sale of the replacement property that would offset the income tax savings of the pre-death exchange.

The decedent's estate is apparently not a "related person" to the beneficiaries of the estate. Therefore, transactions between the estate and the beneficiaries are not subject to the related party rules of Section 1031(f). Accordingly, a taxpayer-beneficiary could exchange his or her low-basis property for the estate's high-basis property. Because the estate received a stepped-up basis in the decedent's property upon the decedent's death, the estate can sell the property for little or no gain to a third party and distribute the cash to the beneficiary. Or the estate can distribute the property it receives in the exchange to the beneficiary who is then receiving his or her relinquished property back with a fully stepped-up basis.

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