

Decrease Estate Taxes with a Real Property Deficiency Study

The five most often-overlooked words in the Tax Code provide an opportunity to lower fair market value.

BY MARK DE STEFANIS



If there ever were a “good year to die,” that would have been 2010.

Ironically, the 2010 Tax Relief Act erased that prospect by retroactively reinstating the estate and generation skipping transfer taxes. While the blow may have been softened from the expiring Economic Growth and Tax Reconciliation Act of 2001, being the beneficiary of a prized piece

of real estate still comes with a heavy price tag. In some cases, the tax bill can leave the beneficiary scrambling to come up with the funds. However, counsel can significantly reduce the IRS take by recommending a Real Property Deficiency Study. In most cases, the benefit can more than offset the professional fees.

Inherited real property can bring unexpected complications that tax preparers, attorneys and accountants must tackle. The property is subject to a 35 percent tax on its value exceeding \$3.5 million. Such a tax can have a devastating effect on the survivors trying to maintain ownership.

To determine the tax bill, the executor is required to calculate the fair market value of all the assets, including real estate. With regard to marketable securities, this exercise is straightforward. However, when the estate includes real property, it is time to get an appraiser involved.

While it is necessary to hire an appraiser to provide the FMV of the property, this is only the first step in the due diligence process that would be employed in an arm’s length transaction. In fact, if you read an appraisal, the appraiser strongly recommends that the buyer retain the services of a

Professional engineer and environmental consultant to guard against deficiencies that the appraisal is not intended to uncover.

Regulation Section 20.2031-1 defines FMV as “the price at which the property would change hands between a willing buyer and seller, neither being under any compulsion to buy or sell having reasonable knowledge of relevant facts.” Attention: these five words essentially allow an estate to justify a reduction in the FMV, which in turn will reduce the estate tax due. These words are not new. In fact, they have been in the Code way before the TRA 1986, and can be counsel’s secret weapon for the beneficiary. Ignoring these five words is a missed opportunity for tax attorneys and estate tax advisors to employ all available means to protect the taxpayer from burdensome real property estate taxes.

The Critical Appraisal

The IRS requires the estate to calculate the FMV of the real property. To do so, the estate tax preparer typically engages the services of an appraiser. Essentially, the five magic words represent an opening to reduce the real property’s FMV to a level that truly represents an arm’s length transaction.

Depending upon the type and use of the real property, the appraiser may use one or all three of the valuation methods available: replacement cost, income, and a sales comparison. The three methods are synthesized to conform to the specific property. Each approach has one common shortfall: they do not address the property’s structural defects, accrued physical deterioration, building code and American with Disabilities Act compliance, environmental liabilities, etc.

The replacement cost approach does have its accrued physical deterioration component, and the income approach does generally use a basic square foot allowance for repairs. However, each approach is no substitute for a professional engineer who has been trained in the preparation of a comprehensive study that identifies the remaining useful life of each building system.

To this end, even though valuations are currently experiencing downward pressure, one should never overlook the underlying physical issues of improved real estate. This becomes even more critical if the property has significant deferred maintenance and is going to require new ownership to step up and invest additional capital.

Appraisal Limiting Conditions

The Appraisal Institute’s standard limiting conditions exclude the professional from opining on items that could substantially diminish the value. These items include structural issues, latent defects, environmental conditions, deferred maintenance, physical deficiencies, building codes, ADA compliance, etc. More specifically, the standard language is:

“It is assumed that there are no hidden or unapparent conditions of the property, subsoil, or structures that render it more or less valuable. No responsibility is assumed for such conditions or for obtaining the engineering studies that may be required to discover them.”

Should a property be encumbered with any such deficiencies, the costs to remedy these conditions should be taken into consideration when seeking to determine the property’s FMV for estate tax purposes.

Reasonable knowledge of relevant facts represents the same approach a buyer would take to value a property during a purchase transaction.

“A Real Property Deficiency Study is one that identifies and documents physical deficiencies, deferred maintenance, and issues of noncompliance with codes. Cost estimates, along with photographs, will document the basis for such a report’s opinions.”

Real Property Deficiency Study

A Real Property Deficiency Study should include a preparer certification, scope of work, methodology (standard of care applied), property narrative, schedule of deferred maintenance costs, detailed construction costs, photos, professional experience, references to the Internal Revenue Code, and a copy of the engagement letter. The report should stand on its own merits.

Furthermore, a quality provider will always stand behind their product and be available for expert witness support. A quality study should bear in mind that the IRS requires “significant support” to justify estate valuations. To this end, the Real Property Deficiency Study should be submitted along with all other information to support Form 706 (Federal Estate Tax Return) FMVs.

A recent deficiency study completed by our firm identified significant deferred maintenance and physical deficiencies totaling about \$1,070,000 for a property that was being transferred. The gross estate was well in excess of the minimum threshold, and included a 110,000-square-foot office building that had structural deficiencies. Furthermore, there was substantial deferred maintenance in other areas, including parking lots, façade, exterior paint, roof covering, etc.

Although the appraiser submitted a report that identified an FMV of \$7.95 million, the Real Property Deficiency Study found that the cost to remedy the deficiencies totaled \$1,070,000 – thus reducing the building’s total value to \$6.88

Real Property Deficiency Benefit Analysis

Description	Appraisal Only	Appraisal & Real Property Deficiency Study
FMV—Appraisal	\$7,950,000	\$7,950,000
Less: Deferred Maintenance	-	(1,070,000)
Add: Appraisal Repairs	-	75,000
Adjusted FMV	\$7,950,000	\$6,955,000
Taxable Estate Threshold	\$5,000,000	\$5,000,000
Taxable Amount	\$2,950,000	\$1,944,000
Estate Tax Due at 35%	\$1,032,500	\$684,250

million. The appraiser did provide a general allocation for deferred maintenance of \$75,000, which equated to only \$0.68 per square foot under the income approach. But the appraisal estimate was grossly understated compared to the documented physical deficiencies of \$9.73 per square foot outlined in the Real Property Deficiency Study.

The documented structural deficiencies, needed repairs, code issues, and maintenance required for the real property components of the building helped significantly reduce the FMV. This documentation served as the required “significant support” and produced a tax savings of \$348,250.

Timing the Estate Tax Strategy

The most common question posed by estate tax attorneys and tax preparers is: “Should I have a deficiency study conducted before or after an appraisal is completed?” Ideally, the Real Property Deficiency Study would be completed prior to the appraisal and should be discussed with the appraiser.

A short call with a professional who understands the purpose of the study can identify a ballpark range of the benefits involved based upon age, size, construction, use, etc. Usually some of the most significant benefits are derived from the maintenance required on the building envelope.

The cost of a real property deficiency study should always be based upon a lump sum fee derived from the amount of time the consultant anticipates to be associated with the preparation of the entire report.

The IRS will vigorously challenge studies that it finds were prepared on a contingency basis. The consultant selected should discuss the parameters of the assignment, including how many days are anticipated for its completion, the amount of time they intend to be on-site, and who will be assigned to the project and their relevant experience.

Furthermore, attorneys should also include the amount of time they expect to interact with the consultant, the time for reviewing draft and final reports, and the coordination required with the appraiser.

Ongoing Tax Benefits

Following the establishment of the FMV, the beneficiary has another opportunity to help minimize ongoing tax payments. The use of a Cost Segregation Study to accelerate the depreciation deduction is also in the arsenal. A Cost Segregation Study parses real versus personal property improvements into their correct categories. This IRS-sanctioned procedure helps reduce the average recovery, thereby accelerating the depreciation deduction to help pay for the estate taxes incurred.

A comprehensive estate tax strategy, including a Real Property Deficiency Study and a Cost Segregation Study, is critical to minimize the estate tax and ongoing income taxes. Tax preparers and estate attorneys can differentiate their practices from those of their colleagues by engaging tax and engineering experts to prepare a Real Property Deficiency Study and Cost Segregation Study as soon as a ballpark estimated value of a property is known. The additional fee to have these studies completed is always dwarfed by the tax savings that such studies generate. ■



Tax Engineering & Cost Audit Services

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