Deep in the Heart of Taxes

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Income taxes garner a significant amount of attention, but there are a couple of other taxes that investors and other real estate professionals should keep in mind: the estate tax and the ad valorem tax, also known as the property tax. These two taxes couldn't be more different, yet they both, in their own way, can take a bite out of a property owner's pocketbook.

The estate tax can be quite expensive. It can hinder you from leaving property to your children and other family members. With effective planning, the estate tax can be reduced to manageable dimensions.

The property tax is always present. Inflation and market forces that increase demand over supply have the unfortunate side effect of potentially increasing property taxes. Like the estate tax, property taxes can be expensive. In fact, for real estate investors or professionals, they're among the largest expense items.

Estate Tax

In terms of the daily decisions a real estate professional has to make, the estate tax is not front and center. Income taxes are constrained by the annual tax year. The typical real estate professional focuses on purchase and sales of real estate and the income tax consequences for that year. The estate tax, on the other hand, is considered only when planning for the family and passing wealth down a generation or two. In other words, income tax is a short-term planning issue, while the estate tax represents long-term planning. The estate tax is charged to a decedent's estate when assets pass to their beneficiaries.

Takeaway

Real estate professionals should give as much attention to the estate tax and the property tax as they do to income tax. The estate tax is expensive beyond generous exemptions and could disrupt one's plan to leave wealth to loved ones. The property tax, meanwhile, represents a substantial material expense. Planning for increasing property tax valuations is complicated, but a property tax consultant can help.

The estate tax is expensive. After exemptions, the estate tax rate is 40 percent for taxable amounts greater than $1 million. With income tax in 2022, a person reached the maximum income tax rate after working through

seven tax brackets (10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent). His bracket depends on his taxable income and filing status. The estate tax rate starts at 18 percent and rapidly increases to 40 percent if the decedent has property valued at more than $1 million beyond the exemption amount.

The estate/gift tax lifetime exemption amount is currently just over $12 million for decedents who died in 2022 and $12.9 million for decedents who die in 2023 ($23 million for a couple). Those amounts will be halved to around $6 million ($12 million for a couple) on Jan. 1, 2026. This drop has already been written into existing law. Because of the large exemption amounts, few people over the past decade have had a large enough estate to incur an estate tax. The vast majority of Americans will die not owing any estate tax.

More impactful, however, is the fact that the estate tax is imposed on the value of the assets in someone's taxable estate. A property does not have to be sold to incur an estate tax. It is incurred because of death and imposed on what the decedent owned at death. Husbands and wives are commonly treated as a taxable unit, and the estate tax can be arranged to be triggered after both individuals die. When a property is sold, the seller owes income tax on the sale, but those taxes can be paid using proceeds from the sale. With the estate tax, there is no realization event–no sale–but the estate might generate the need for a sale so the surviving family will have the cash to pay the estate tax. When a property is sold, the seller owes income tax on the sale, but those taxes can be paid using proceeds from the sale. With the estate tax, there is no realization event–no sale–but the estate might generate the need for a sale so the surviving family will have the cash to pay the estate tax.

Minimizing the effect of the estate tax and passing wealth on to loved ones smoothly, efficiently, and with as much privacy as possible takes careful thought and planning. Just having a simple will is insufficient. Tax professionals, such as tax lawyers and accountants, can help. They can also help individuals avoid the disruption of having to pay the estate tax nine months following the decedent's death through planning built around sufficient liquidity.

Property Tax

The most unpopular tax in Texas is the property tax. Charles E. Gilliland, rural land expert for the Texas Real Estate Research Center, has written extensively about the good, the bad, and the ugly aspects of the Texas property tax, noting:

- it requires a large one-time payment;
- payment disregards taxpayer's financial condition;
- property tax amounts are driven by budget requirements of local governments;
- market dynamics shift the tax burden beyond taxpayer control (e.g., areas of rapid growth have an increasing tax burden); and
- many taxpayers question fairness of the property tax, the process, and the integrity or competence of appraisal districts.

People from out of state are often attracted to Texas' lack of an income tax, only to relocate and discover the state's property tax is the 6th highest in the country. That tax is increasing at an astonishing rate. In its 2018-19 report, the state comptroller's office reported property taxes totaled $52.2 billion in 2015 and $73 billion in 2021, a $20 billion (38 percent) increase. Texas Governor Abbott and Lt. Governor Patrick in February 2023 have both prioritized property tax relief for the current 88th Texas Legislature in the amount of $15 billion.

Property taxes are computed using property values and tax rates. Some local governments have lowered tax rates to compensate for the higher values, but total property tax amounts have increased. Texas' property tax code includes protections for property owners. The homestead exemption, which limits increases in taxable value of a home, is one such protection. Another that was recently enacted requires taxing bodies to obtain voter approval before increasing property tax revenue more than 3.5 percent from the prior year (2.5 percent for school districts). Importantly, new property developments are excluded from the 3.5 percent growth limits.

Appraisal districts assess property values each year and notify property owners of a property's worth. The process starts every Jan. 1, which is the valuation date of taxable property. By April 15, taxing authorities notify taxpayers of their property's taxable value for the year. The deadline for property owners to administratively appeal the proposed taxable values is May 15 (or the 30th day after the property owner received the notice of value, whichever is later). By July 25, each chief appraiser certifies the tax roll for each taxing unit participating in that district. By Sept. 30, taxing jurisdictions adopt new tax rates.

All taxable property must be appraised at market value by Jan. 1 each year. Market value is the price at which a property will transfer for cash or its equivalent under prevailing market conditions if:

- it is offered for sale in the open market with a reasonable time for the seller to find a purchaser;
- both the seller and purchaser know of all the uses and purposes for which the property is adapted and for which it is capable of being used, and of the enforceable restrictions on its use; and
- both the seller and purchaser seek to maximize their gains, and neither is in a position to take advantage of the need or demand of the other.

When appraising properties, appraisal districts most commonly use the sales comparison (market) approach, the income approach, or the cost approach.

Sales Comparison (Market) Approach

This approach starts with sales prices of similar properties that have recently sold, then adjusts the comparable properties to account for differences with the property being appraised.

The sales comparison approach is the valuation method typically preferred in appraising single-family homes and vacant land in mass appraisal when adequate sales data are available.

Income Approach

Here, income and expense data are used to determine the present worth of future benefits. This approach seeks to determine what an investor would pay now for a property based on its anticipated future revenue stream.

The income approach is most suitable for properties frequently purchased and held for the purpose of producing income, such as apartments, retail properties, and office buildings.

Cost Approach

The cost approach is based on what it would it cost to replace a building with one of equal utility. Depreciation is applied, and the estimate is added to the land value.

The cost approach is especially useful for appraising unique properties, new construction, and properties for which sales and income data are scarce.

Pandemic's Effect on Valuations

The pandemic and the resulting economic dislocation have raised uncertainty regarding the valuation of taxable property, especially commercial properties. Appraisal district valuations are based on historical data, so valuations are only now going to reflect the economic pain of 2020 and 2021.

What effect will office and retail vacancy rates have on property tax valuations? If a portfolio contains commercial property with substantial tenant vacancies or perhaps mortgage defaults, economic disruptions will likely affect property tax valuations.

The best advice for real estate professionals is to keep alert on what is going on with appraisal district valuations.

Property Tax Consultants

One compelling strategy for keeping current with appraisal district valuations is to appoint a property tax consultant. They are experts at real estate valuation, and they monitor developments at the appraisal district and work to protest high valuations. They also monitor deadlines. Missing an important deadline will limit the options to protest a valuation and could result in late fees, penalties, and interest.

Property tax consultants are typically paid a contingency fee. In other words, they're paid a percentage of the taxes saved. Appointing a tax consultant is easy. Use Texas Comptroller Form 50-162 to make the appointment.

Nothing in *TG* should be considered legal advice. For legal advice on a specific situation, consult an attorney or tax attorney.

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