Not-So-Obvious Real Estate Investment Tax Strategies

William D. Elliott
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Some tax strategies for real estate investors are so common and so elementary that they are often overlooked. However, they are no less effective. Here are a few.

Key Takeaways

- Convert separate property into community property.
- Retitle community property into each spouse's name.
- Gift tax applies to the transfer of asset value from one generation to another.

Converting Separate Property into Community Property

Texas is a community property state. The idea behind community property is that the family is a basic, single social unit. Each spouse with community property owns an undivided one-half share of the marital assets. This includes assets acquired during marriage, no matter whose name is on the deed or title.

Exceptions to the community property rule are for gifts to or inherited by a spouse or assets acquired before marriage. These are separate property, not community property. With separate property, title matters. The person whose name is on the deed or account statement owns separate property.

Many people are moving to Texas, and they usually bring with them separate property from their former locations (unless they moved from one of the few other community property states). If they start acquiring Texas assets, such as a home, they'll own a mix of separate and community property. Very few think about what to do with their mixed separate and community property. The obvious strategy is to convert separate property into community property.

One distinct tax advantage of community property is the double step-up in basis. Under federal income tax law, IRC § 1014(b)(6), all community property (including both the decedent's one-half interest in the community property and the surviving spouse's one-half interest in the community property) receives a new basis equal to its fair market value on the death of the first spouse. When a spouse dies, the cost basis for both community one-half interests is stepped-up, and the assets may be sold by the surviving spouse without recognizing a capital gain. This tremendous tax benefit is unavailable for separate property. The conversion, which is handled by written agreement, is reasonably simple. If it is such a great strategy, why don't more people use it? There are several reasons:

- Inertia.
- Being uninformed.
- The possibility of divorce.

In a divorce, generally speaking, separate property is off limits in the division of property. If a spouse owning separate property doubts the marriage will last, self-interest dictates keeping separate property separate.

Retitling Community Property into Each Spouse's Name

Valuation advantage is another benefit of converting separate property into community property. Not only should those with a net worth over $27 million (using 2024 exemption amounts) consider converting separate property to community property, they should title the community one-half interests in each spouse's name.

> Example 1: A husband and wife own 1,000 shares of stock in Widget Co. as community property. The stock is re-issued with 500 shares in the husband's name and 500 in the wife's name.

In that example, the stock remains community property whether titled to one or both spouses. Having both spouses' names on the deed, title, or account statement creates an opportunity for valuation discounting, because neither spouse owns a majority of the corporate stock. Therefore, an appraiser of the corporation will consider a non-control discount. This type of discount could range up to 15 or even 20 percent.

> Example 2: A husband and wife own 1,000 shares in Widget Co. but the shares are titled in the husband's name. The company is valued at $1 million. On the husband's or wife's death, each of their taxable estate value is $500,000.

> Example 3: Same facts as example 2, except the husband and wife each own 500 shares and have separate stock certificates. If the husband or wife dies, the value of his/her half is potentially subject to a 20 percent valuation non-majority control discount (meaning the taxable estate value would be $400,000, not $500,000).

With this very slight change in ownership, the couple takes advantage of a valuation discount.

Gifting An Investment Opportunity

Real estate investors who have accumulated a portfolio often give a great deal of thought to how to transfer some of the parents' wealth to children or grandchildren with the least gift tax. Common strategies focus on minimizing taxable value of the properties through family partnerships and trusts. At the heart of these strategies is the reality that the gift tax applies to the transfer of asset values from one generation to another.

The gift tax is imposed when one individual transfers property to another while receiving nothing, or less than full value, in return. This definition encompasses numerous gifts that may not initially appear to significantly affect gift tax reporting. In 2023, each taxpayer had a $12.92 million lifetime exemption available to use during life or at death to transfer assets tax-free to others. That exemption increased to $13.61 million in 2024. Many are concerned that the exemption amount is scheduled to drop on Jan. 1, 2026, to about $7 million, indexed for inflation. In addition to the lifetime exemption, annual gifts worth $17,000 or less per donee (person who receives a gift) in 2023 ($34,000 if splitting gifts with a spouse) are excluded from the available lifetime exemption.

Consider the following examples:

> Example 4A: A parent buys some real property and gifts the property to a trust for the child. A gift tax will be imposed on the value of the real property, which would presumably be the recent purchase price.

> Example 4B: Rather than purchasing the real property herself, the parent uses an existing trust for the child to purchase the property. Since existing money in the child's trust was used, no gift tax should be imposed. There was no gift to the child. The parent only gave the child an opportunity.

Each of these strategies contains details and nuances not addressed in this article, and each requires careful planning. Before making any financial decisions, consult an attorney or a tax professional.

William Elliott (bill@wdelliottlaw.com) is a research fellow with the Texas Real Estate Research Center and a Dallas tax attorney, Board Certified, Tax Law; Board Certified, Estate Planning & Probate; Texas Board of Legal Specialization; and Fellow American College of Tax Counsel.
