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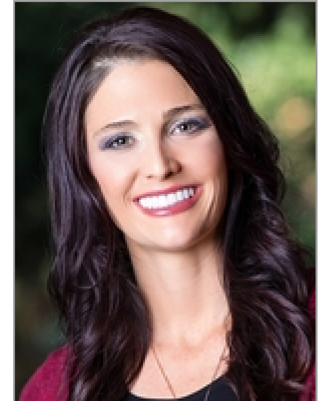
When The Cost Of Inheriting Property Far Exceeds Its Value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Law360, New York (March 22, 2016, 11:34 AM ET) -- When it comes to inheriting wealth, real estate is a prime asset class. Real estate often generates a substantial passive income stream, guards against inflation, and grows dramatically in value over the long-run. One need only think of Donald Trump.

Trump is known for being one of the wealthiest men in the U.S., with an estimated net worth in the billions. Trump’s father, Fred Trump, was a real estate developer who left an inheritance to his children worth an estimated $40 to $200 million.

Donald Trump then leveraged his inheritance in high-value real estate to grow his own real-estate empire, now valued in the billions. Trump did not start from nothing; rather he had a nice nest egg, which he then grew. So if you want to give your children a head start, you should leave them your residential, commercial and industrial properties, right? Not so fast. Although real estate can be a phenomenal investment and valuable inheritance, there are times when the cost of owning real estate far exceeds its value. Consider the relatively recent advent of toxic succession. As the U.S. continually works to clean up its past environmental errors, the environmental requirements and regulations of owning property continually become more stringent. Many times, in order to either develop or sell a property, numerous environmental reports need to be issued.

As the population and economy of California have changed, zoning regulations have also changed to accommodate. Property previously zoned for heavy industrial use, for example, was later zoned residential. Many times the previous industrial use left contamination that, if left untreated, would pose a tremendous health risk to residents. For this reason, if a real estate developer wants to develop property, she needs to secure costly environmental reports. If contaminants are uncovered, they must be cleaned up before the development can occur. Oftentimes, the cleanup is dramatically expensive, ranging from tens of thousands to millions of dollars.

Consider the following example: Jeff and Megan Jones owned a substantial amount of real estate, including a vacant lot in a formerly industrial section of Los Angeles.

Over the last 20 years, this industrial area slowly became residential, with warehouses being replaced by multi-family dwellings. Jeff and Megan had always planned to sell their vacant lot to a real estate developer. Unfortunately, Jeff developed Alzheimer’s and Megan spent the majority of her time caring for him, so they pushed the vacant lot to the proverbial “back burner.” However, the family wasn’t worried. Real estate prices in the Los Angeles area continued to rise, and the children were more than happy to inherit the property.

Fast forward 10 years. Both Jeff and Megan have passed on. Their estate has been divided three ways, with each of their children receiving an equal share of the vacant lot. The three siblings co-own this parcel, which they agree to sell to a developer. They have the necessary environmental inspections completed, only to find that there are contaminants on the property that must be removed before any development can occur. The environmental cleanup is estimated to cost between $700,000 and $1.2 million.

The current owners are forced to either clean up the toxic mess, or hold on to a vacant lot indefinitely. The siblings need to pay property taxes associated with the parcel, and will continue to incur losses if the property is neither sold nor developed. In a best-case scenario, the current owners and developer can share the clean-up costs. In a worst-case scenario, the developer walks away and the siblings must either clean up the contamination or face the economic burden of holding an unsellable vacant lot.

This is just one of many examples of times when an inheritance is a costly expense, not a beneficial source of wealth accumulation. Environmental toxins are only one example of when the costs associated with an inheritance can outweigh the benefit. Other examples include inheriting property that is in ill-repair or property that is burdened with excessive debt.

The easiest way for an heir to avoid inheriting an asset that would be better classified as a liability is to make sure the trustee or executor has done due diligence before the property is distributed.

When an estate is in the administration phase, i.e. the phase following the death of the property owner, the assets continue to be owned by the estate. During this time, the estate is liable for paying any costs associated with the estate administration. The ownership, and subsequent liability, don't transfer to the beneficiaries until the administration phase is complete and the title is formally transferred. This means that the estate has the liability, not the beneficiaries. For this reason, it is essential that the trustee or executor know the condition of the property prior to making a distribution.

During this administrative phase, it would be wise for the trustee or executor to gather any and all reports regarding all property. This has traditionally included appraisals, but for a potentially polluted property, an environmental report is a wise addition. If any contaminants are found, the estate can be responsible for any cleanup and other expenses. This is especially advantageous with large estates, where the trustee or executor may be able to sell property in order to cover the costs associated with keeping another property. It also protects the beneficiaries from being saddled with an unwanted liability.

As part of the due diligence, the trustee/executor should also understand the insurance policy. Does the insurance cover environmental contaminants? What are the coverage limits? Can coverage be extended? The executor/trustee can then make any changes/modifications to the insurance policy prior to distributing the property to the beneficiaries. Upon receiving the inheritance, the beneficiaries should also know the ins and outs of the respective insurance policy.

By knowing what type of burdens accompany the proposed inheritance, beneficiaries can also make an informed decision as to whether to accept the inheritance. If a beneficiary does not want to receive an inheritance, he or she can exercise a disclaimer and the property will pass to the next beneficiary in line. If all potential beneficiaries exercise a valid disclaimer, the property will eventually pass to the state.

Unfortunately, once ownership transfers to the beneficiaries, any debts, liabilities and costs associated with the property accompany the transfer. In the case of toxic succession, a beneficiary can be liable for the environmental contamination, no matter what the cost.

A good rule of thumb is inheritor beware. Just as when a homebuyer endures a wide variety of inspections and disclosures, if you are about to inherit property, you will want to exercise the same due diligence. You will want to be certain that the trustee/executor has conducted appraisals and environmental reports, so you know exactly what you are inheriting and what condition it is in.

If you are serving as a trustee or executor, make sure you've done all due diligence. Every trustee is in a fiduciary role and must act in the best interest of the beneficiaries. A breach of this fiduciary duty is a liability for the trustee. So whether you are administering or inheriting an estate, know the ins and outs of every piece of property. Although it will take time to gather these details, this will offer substantial protection in the long run.

—By Manya Deva Natan, SSS Legal and Consultancy Services

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