Asset Basis and the Future of the Federal Estate Tax

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08/17/2021

The federal estate tax is often a topic of conversation especially in regards to the tax rate and the applicable credit or exemption amount; however, currently another aspect of the estate tax is getting attention – Basis. In order to evaluate and understand the proposed changes to the estate tax law you must first understand what basis is and the different ways that basis can be determined for tax purposes.

Basis is typically determined based on what you paid for an asset. This can be the amount you pay in cash, the amount of debt you incur in paying for the asset, or the value of other assets or services you exchange in return for the asset. Basis is then used for tax purposes to determine your gain or loss on the later sale of the asset. It is also used to determine depreciation, amortization, depletion and casualty loses. Your basis in an asset is not necessarily stagnant. For example, it can be increased by the costs of improvements or decreased by items such as depreciation.

But how is basis determined if you inherit the property from someone else at death? You did not pay for the asset, so is your basis zero? In most cases, the answer is no, your basis is not zero. Under the current estate tax law when you receive an asset from someone at their death, your basis becomes the fair market value of the asset on the person's date of death.[i] This is often referred to as a step-up in basis.[ii] This step-up in basis allows for the gain that occurred in the asset during the life of the decedent to escape capital gains taxation. For example, let's consider a piece of commercial real estate purchased in 1995 for $200,000 and in 2021 that real estate is now worth $700,000. If the owner sells the real estate the owner would owe capital gains tax on $500,000, the difference between the sales price and the owner's basis in the property. Now if the owner died in 2021 and left the property to his or her child and the child then sells the property the day after death for $700,000, the child would pay no capital gains on the sale because the child's basis in the property stepped-up to the fair market value on the date of death of $700,000. As you can see the ability to step-up basis on death can provide a significant tax savings to the heirs of an estate.

The way basis is determined at death is different from the way basis is determined if the property is gifted during life. While the estate tax uses a step-up in basis, the gift tax employs what is known as carryover basis. With carryover basis when you receive a gift of an asset from someone while they are alive, you take that person's basis in the assets.[iii] Thus, if you later sell the property you will have the same gain on the sale that the person you received the property from would have. Looking back at our example above with the commercial real estate purchased in 1995, this means that if the owner gifted the property to his or her child in 2021 and the child then sells it for $700,000, the child would owe capital gains tax on $500,000 because he carried over the parent's basis of $200,000, even though the property was worth $700,000 at the time of the gift. Thus, you can see how different the treatment is between assets transferred by gift versus assets transferred at death.

There are currently several different proposals in regards to the federal estate tax but at least two, including the one favored by President Biden, would call for a carryover basis on assets inherited as opposed to the current step-up in basis[iv]. If you couple the loss of the step-up in basis with a potential increase in capital gains rates, this could dramatically affect the ability to transfer wealth at death, even if the capital gains tax is not incurred until the asset is later sold by the child.[v]

Not only would a carry-over basis result in an increase in capital gains tax but it also poses a potential documentation nightmare. A benefit of step-up in basis is that the basis is determined at the date of death, whereas with a carryover basis you must know what the deceased's basis in the property was. Establishing what the deceased paid for an asset decades ago can be daunting. For example what did your grandfather pay for his house in 1950? How much did he spend when he added on a bathroom in 1982? You have to have that information to determine the carryover basis at his death. As you can see accurately determining your carryover basis after the purchaser has died can be daunting. At least with a gift, the person who purchased the asset is still alive and can provide assistance in determining the carryover basis.

There are numerous proposals on the estate tax return and each approaches the changes to the estate tax differently. What if anything will be adopted is up for debate, but hopefully you will now understand a little more about the issues involving basis.

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[i] Basis may be determined at other than date of death if an alternate valuation date is chosen by the executor of the deceased's estate or if special-use valuation is elected.

[ii] A step-down in basis can also occur if the fair market value of the asset is below the deceased's basis.

[iii] For ease, this discussion will only focus on assets that have a fair market value greater than their basis at the time of gift.

[iv] President Biden's plan would allow for an exclusion of up to $1 million in gains and also some potential exclusions for family-owned businesses and farms if certain requirements are met.

[v] Under current law, gain is generally not recognized until an actual sale occurs and death is not considered a sale. Thus, in our example involving the commercial real property purchased in 1995, if you assume carryover basis at death, then under traditional tax principals, when the owner dies the child will take the parent's basis in the property of $200,000 and would pay no capital gains tax until he later sells the property. If he does not sell the property until 2030 then he would pay no capital gain until that time. The gain he paid in 2030 would be based on the difference between the sales price and his $200,000 basis. However, under at least one proposal the gain would be recognized at death instead of later sale. Thus, the $500,000 gain would be recognized in 2021 even if the child held the property and did not actually sell it until 2030. Essentially this proposal would treat death as a sale of assets.