



Advanced Markets Blog

Repeal of the step-up in basis at death? What might that look like?

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For many years, politicians and tax professionals have discussed the many reasons beneficiaries should or should not receive a so-called “step-up” in basis at the time of the decedent’s death. The US federal tax law at the time of this writing provides for such a step up. President Biden has proposed repealing the step up and instead, proposed taxing any gain at the time of death. Before we get into any discussion of the reasons why one might prefer one path or the other, let’s lay some foundation.

Basis basics: “Basis” is the starting point from where we measure taxable gain in property. When a taxpayer purchases property, the taxpayer generally takes basis in the amount of the cash or other consideration paid for the property (assuming that the taxpayer pays a purchase price of the full fair market value for the property). The taxpayer’s basis may be adjusted for certain improvements to the property if permitted by law. If the taxpayer sells the property later on, the taxable gain will be the amount of the purchase price in excess of the taxpayer’s basis in the property, if any. For example, a taxpayer who purchases a house for \$350,000 will generally get a starting basis of \$350,000 regardless of how the taxpayer purchases the house (cash or loan proceeds). If the taxpayer puts a new roof on the house after a couple of years, at a cost of \$7,000, the taxpayer’s basis is increased to \$357,000. If the taxpayer later sells the house for \$500,000, then the taxpayer’s taxable gain is \$143,000 ($\$500,000 - (\$350,000 + \$7,000)$). (For purposes of this discussion, we will ignore certain available exclusions from taxable gain from qualifying sales of a primary residence.) The gain on the sale may be capital gain or ordinary income depending on the type of property sold and the reason the seller held the property. Basis applies to assets such as real estate, business interests and even stock portfolios — and tracking basis is easier for some assets than others. It should be noted that qualified plans (IRAs, 401ks, etc.) generally do not receive basis for tax-deductible contributions to such plans (which most contributions are).

Step-up in basis at death: In addition to adjustments to basis for improvements to property, the Internal Revenue Code (IRC) sets forth a number of other provisions for basis under specific circumstances. For example, IRC §1015 provides that when property is “gifted” to another person (whether outright or in trust), generally the donee will



have the same basis in the property that the donor had just before the gift was made (commonly referred to as “carryover basis”). Another section, IRC §1041 provides that no gain or loss is recognized on the transfer of property, by sale or otherwise, between spouses or between ex-spouses as part of a divorce. The section most important to our discussion is IRC §1014, which provides that the basis of property received from a decedent is the full fair market value of the property at the time of the decedent’s death. This is what is referred to as the step-up in basis at death. From our example above, then, if the taxpayer had made a gift of the house, now worth \$500,000, to the taxpayer’s adult child during the taxpayer’s life, then the basis of the house in the hands of the recipient adult child would be \$357,000 (the same basis in the hands of the taxpayer). If the child later sold the house, the gain would be measured against that carryover basis. If instead the taxpayer left the house to the adult child in the taxpayer’s estate, the basis in the hands of the adult child would be the fair market value at the time of the taxpayer’s death, say, \$500,000. If the adult child were to immediately sell the house for \$500,000, no tax on this gain would be due. The \$143,000 gain would never be taxed.

Behavioral consequences of the step-up in basis at death: Federal income taxation is only one tax that property may be subject to upon transfer. If the transfer is a gift, then transfer taxation (gift or estate tax) may apply. If a decedent’s estate is large enough to be subject to federal estate tax, holding onto property until death will usually mean that the fully appreciated value of the property will be included in the decedent’s estate and taxed at the marginal applicable rate. However, for such a taxpayer, a gift during life will also be taxable at the same rates (although the lifetime gift is “tax exclusive” while the gift at death is “tax inclusive”). Escaping income tax on gain by transferring property at death, instead of transferring the property during life, is a strong incentive to hold onto property even when there are other compelling reasons to transfer it during life. Often this “tax tail” will wag the “planning dog.” This tax influence creates a negative externality in that the most efficient timing of a property transfer may not be chosen solely because of tax considerations. The tax law could work to confuse taxpayers’ efficient management of their property while reducing tax revenues available to the government. Imagine the tax revenues that are forever lost on the family property that is handed down from one generation to the next over multiple generations. As we will also see, this foregone tax revenue regressively benefits the wealthiest taxpayers, but its loss is borne by all citizens that the government serves.

What repeal would likely look like: President Biden’s proposals have evolved slightly, but the general rule has remained that a recipient’s basis in property received from a decedent would no longer be stepped up by IRC §1014 to the full fair market value as of the date of the decedent’s death. Thus, as a baseline, basis in the recipient’s hands would be carry-over of the decedent’s basis under IRC §1015. If this repeal is enacted as proposed, in addition, any gain in the date-of-death value of the property in excess of this carry-over basis would be subject to taxation at the time of the transfer. Of course, this payment of tax on the gain would result in an increase in the basis of the property in the hands of the recipient to the full fair market value of the property at death – which would result in a de facto step-up in basis – but it would come at the cost of income tax revenues on the gain, reducing the amount available for transfer to heirs at death. Also possible would be a simple repeal of the step up without the proposed realization of gain at death, which would leave the beneficiary with carry-over basis equal to the decedent’s basis and increase taxation of the gain only upon the eventual sale of the asset by the beneficiary, if it ever happens. Either way, the repeal would equalize the tax treatment of transfers at death with the treatment of gifts made during the decedent’s lifetime, though the timing of the taxation could be different depending on how the law is written. There is no way to predict how a final repeal would be drafted, but the Biden campaign proposal included numerous exceptions, such as a step-up amount that could be applied to any property and exclusions that permitted step up of property left to a surviving spouse or certain other family members. Such exceptions may be included in a final bill that might, for example, protect family businesses from taxation on gain at the time of an owner’s death.

Tax consequences of a repeal: Analysis by the Tax Foundation (a prominent independent tax policy think tank) of the tax consequences of repeal indicate that the tax burden of the repeal would land primarily on the very wealthy and the moderately wealthy but would likely be felt more sharply by the moderately wealthy. This is driven primarily by the fact that those taxpayers own a disproportionate amount of the assets, expressed both in terms of quantity and market value gain, that currently receive a step-up in basis. These taxpayers also benefit from tax-planning advice that less wealthy taxpayers cannot afford and are therefore more likely to use the step up strategically. Many tax professionals see the current step up, and the loss of tax revenues attributable to it, as an expensive tax expenditure that favors almost exclusively the top 20% of wealth owners in the country. Repeal is projected to increase tax revenues by \$116 billion in the first ten years after repeal. Likewise, repeal would put lifetime gifting and testamentary gifting on an equal taxation footing and remove the tax-savings advantage enjoyed by the wealthiest taxpayers. Some commentators have pointed at the recordkeeping necessary to track an owner's basis in the property as a reason not to repeal, but this recordkeeping has always been and remains necessary as well for any sale before death, so this argument is essentially one serving only continued procrastination late in an owner's life.

It is worth remembering that the repeal of the step-up in basis is one of many proposals that comes up almost every year and in almost every presidential election, but so far has never succeeded. Whether it will be accomplished by this administration and, if so, what form it will take remains to be seen. This year, the administration has competing and pressing issues to address, including facilitating the vaccination of approximately 330 million citizens, stimulating an economy in recession, and providing aid to citizens in need, just to name a few. While tax revenues generated by this repeal may help increase revenues overall, a repeal may not be at the top of the very long list of priorities. We will follow any developments in this area and report them to you as they come to light.

Conclusion

Currently, there is a lot of talk about increase in taxation and taxes are top of mind for many individuals and financial professionals. Clients with protection and estate-planning needs can look to permanent life insurance as a vehicle to help offset some of the taxation that exists today and may exit in the future. A tax-free death benefit can provide enhanced value to cover the needs of clients and be a tax-efficient means of covering the impact of taxes — ultimately protecting and enhancing legacies for spouses, children and grandchildren.

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