



Loss of Basis Step-Up at Death and Increase in Capital Gains Tax

Michael C. Zahrt

Foster Swift Trust & Estates Law News

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The Internal Revenue Code (the "Code") currently taxes long-term capital gains at lower rates than ordinary income. Depending on the taxpayer's taxable income, the current rate is between 0% and 23.8% (including the Net Investment Income Tax). The Code also currently provides a "step-up" in basis upon the death of a taxpayer, which causes the tax basis of an asset to be increased to its fair market value on the date of the taxpayer's death.

The Biden Administration proposes drastic changes to this tax regime. Specifically, taxpayers earning more than \$1 million would be taxed on capital gains at ordinary income rates. This would cause the tax rate on long-term capital gain to be nearly doubled, from 23.8% to 43.4%.

The Biden Administration would also eliminate the step-up in basis, which would impact taxpayers of any income level.

The current strategy for long-term capital assets is to defer capital gains for as long as possible. This allows the asset to appreciate free of tax, and if held until the taxpayer's death, the tax on the gain is essentially forgiven. The most common instance of this occurrence is the sale of a deceased taxpayer's personal residence. Children are currently able to sell their parents' home after their death and keep all of the proceeds because the tax basis of the home is stepped up to its fair market value.

Under the proposed changes to the Code, beneficiaries of an estate would owe capital gains tax in connection with the sale.

The loss of the basis step-up and the increase to the capital gains tax rate would most drastically impact high net worth business owners. As discussed by Amanda, above, the proposed reduction to the federal estate tax Exclusion Amount would cause married taxpayers with a net worth of over \$7 million to be subject to estate tax. If the loss in step-up is not coordinated with the reduced lifetime Exclusion Amount, the owner's heirs will be left with a significant tax bill. Take, for

AUTHORS/ CONTRIBUTORS

Michael C. Zahrt

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example, a widowed taxpayer who owns a business worth \$17 million.

To keep the example simple, further assume she has not used any of her or her deceased spouse's Exclusion Amount (under a Biden proposal, \$7 million) and has basis of zero in the business.

If the taxpayer leaves her business to her children, her gross estate will exceed her total available exclusion amount by \$10 million. At a new rate of 45%, this would lead to an estate tax bill of \$4.5 million. The taxpayer's children would likely need to sell the business to create liquidity to pay the estate tax bill. Without a step-up in basis, the children would owe capital gain on the full \$17 million at a rate of 43.4%, which amounts to \$7.378 million. Thus, the total tax bill paid at the widow's death would be \$11.878 million, and the children would only be left with \$5.122 million – an effective tax rate of 69.87%!

We hope the Biden Administration will coordinate a loss of step-up with the reduced Exclusion Amount. Still, it highlights the need to critically examine your business succession plan and determine whether immediate action is advisable. Foster Swift has a number of business succession planning resources available, and our attorneys are happy to discuss succession planning options for your business specifically.
