When the Stepped-Up Basis of Inherited Property Is No More

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In trying to discern how trust and estate law will be different in the years ahead, it is very difficult to overstate the impact of one particular tax change that is being actively promoted by President Biden – namely, eliminating the so-called "step-up in basis" for inherited property.[1] This rule has been part of the U.S. tax law for as long as anyone can remember and has been an important consideration in family tax planning at every level of wealth. Though the rule has long been a target of tax reformers, perhaps now is the moment when it will meet its demise for many – but not all – American taxpayers. The evolution of this development and its implications are the focus of this article.

Section I explains how the rule operates and its consequences for gratuitous transfers of assets, both *inter vivos* and testamentary. Section II reviews previous efforts to eliminate this provision, including the successful (though ultimately reversed) repeal of this rule in 1976[2] and its partial repeal in 2001.[3] Section III then analyzes the context in which repeal might finally happen and its ramifications for family tax planning, funding of retirement accounts, and charitable transfers.

I. Determining Basis of Inherited Property

The Step-Up-in-Basis Rule was enacted in 1921,[4] only five years after the modern U.S. estate tax itself was enacted in 1916.[5] These two developments were inter-related conceptually and not just temporally. At its essence, the Step-Up-in-Basis Rule provides that when an heir inherits property of any sort, the basis of that property in the heir's hands for income tax purposes will be the property's fair market value

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1 *See* I.R.C. § 1014(a); *see also* Ellen Chang, *Estate Taxes: Will the Step Up in Basis be Eliminated? Here's What to Know and How to Prepare*, Bankrate (May 25, 2021), https://www.bankrate.com/taxes/biden-estate-tax-step-up-basis [https://perma.cc/3AQB-3UM3].

2 *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), 90 Stat. 1520, 1872-77.

3 *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 541-542(a), 115 Stat. 38, 76.

4 *See* Revenue Act of 1921, Pub. L. No. 67-98, § 202(a)(3), 42 Stat. 227, 229.

5 *See* Revenue Act of 1916, Pub. L. No. 64-271, §§ 201-212, 39 Stat. 756, 777-80.

when the decedent died.[6] There has long been an exception whereby an estate's executor can elect to apply an "alternate valuation" based on the property's market value six months after the decedent's death,[7] and a more curious exception was added in 1981 to counter certain tax-motivated transfers between an heir and the decedent during the year prior to the decedent's death.[8] But for the most part, a property's market value on the day the decedent passed away is its basis in the hands of the new owner.

For example, if Beth inherits some stock worth $200,000 that her father Adam purchased many years ago for $50,000, Beth's basis would be $200,000, its value when Adam died. As a result, the increase in the stock's value from $50,000 to $200,000 - namely, $150,000 - is never subjected to income tax to anyone. Adam was not taxed on this gain that accrued during his ownership of the stock because he never "realized" the gain by selling the stock, and Beth does not recognize the $150,000 of untaxed gain because she takes as her basis the stock's value of $200,000 when her father passed away. Accordingly, this rule is commonly denominated the step-up-in-basis rule.

This terminological convention applies even though this phraseology does not, in fact, appear in the pertinent statutory provision, and the applicable rule is not limited to increases in a property's worth. So, if Beth inherits real estate worth $50,000 that Adam purchased many years ago for $200,000, Beth's basis in this real estate is $50,000, its value when Adam died. In this circumstance, the tax rule effected a step *down* in basis rather than a step up. Note that in this example, the failure of Adam to sell the real estate during his lifetime resulted in an economic loss of $150,000 that no one was able to deduct. Adam, after all, could not deduct the loss because he never "realized" the loss during his lifetime, and Beth cannot deduct the loss because she took as her basis in the real estate its $50,000 fair market value when Adam died. In other words, this tax rule is more accurately described as a "reset basis" rule, because it can lead to decreases, as well as increases, in a property's basis when property passes from a decedent. Notwithstanding this reality, the rule is generally labeled the step-*up*-in-basis rule, presumably because well-advised property owners generally retain their appreciated property until they die in anticipation of this special tax treatment.

Be that as it may, this rule contrasts rather vividly with the applicable basis rule for lifetime transfers. In that circumstance, the general

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[6] I.R.C. § 1014(a)(1).

[7] *See id.* §§ 1014(a)(2), 2032(a).

[8] *See id.* § 1014(e)(1). This provision indicates that no step-up in basis will be allowed if the property in question was acquired by the decedent *from the designated heir* during the year preceding the decedent's death.

rule is that the donor's basis carries forward and becomes the donee's basis for income tax purposes.[9] For example, assume that Adam made an *inter vivos* gift of stock worth $200,000 to his son Charles. If Adam had purchased that stock many years ago for $50,000, the stock's basis in Charles' hands would be the same that the stock had in Adam's hands – namely, $50,000. This result – using the same asset values as in the prior example involving Beth – could not be more different. In other words, the simple fact of whether a gratuitous transfer took place before or after the donor died made the tax result completely different.

It is this dichotomy that lies at the heart of the controversy surrounding the step-up-in-basis rule. Carryover of a donor's basis for *inter vivos* gifts derives directly from the tax code provision that excludes the receipt of gifts from a donee's gross income.[10] These two provisions recognize that the transfer to a new owner –typically, but not always, a family member – is simply a change in nominal ownership without any realization of the property's change in value. The donee simply stands in the proverbial shoes of the donor and accordingly will not recognize income from the receipt of the gift but will use her donor's basis if, and when, she sells the property. At that time, the inchoate gain – here, $150,000 – will be recognized.

Interestingly, the tax code provision that excludes gifts from a recipient's gross income applies as well to a "bequest, devise, or inheritance."[11] Therefore, it would seem that the same carryover basis rule should apply to such testamentary transfers with equal force as it does to lifetime transfers. Accordingly, the step-up-in-basis rule is anomalous and discordant with the general framework of the income tax code.

II. The Troubled History of the Step-Up-in-Basis Rule

Although the original reasons for the step-up-in-basis rule are not clear, their main rationale lies in the federal estate tax. That levy imposes a "transfer" tax on the fair market value of all assets owned by the decedent on the date of his or her death,[12] with the possible exception of the "alternative valuation date,"[13] as noted previously. In this context, the taxable base of the properties involved is their entire worth and

[9] *See id.* § 1015(a). An exception applies, however, if the donated property was worth less than the donor's basis at the time the property was given. In that circumstance, the donee's basis is equal to the property's fair market value on the date of gift but only for purposes of determining a loss by the donee. Otherwise, the donor's basis carries over. The operation of this strange rule is illustrated in Treas. Reg. § 1.1015-1(a)(2) (1971).

[10] I.R.C. § 102(a).

[11] *Id.*

[12] *See id.* §§ 2001(a), 2031(a).

[13] *See id.* § 2032(a).

not just the amount of appreciation that has accrued since their acquisition. Thus, a $1 million residence faces an estate tax based on that $1 million valuation, regardless of whether the home cost $100,000 or $980,000 when it was first purchased. Congress apparently was concerned that imposing income tax on an inherited asset's unrealized appreciation after that same property was subjected to the estate tax was inappropriately excessive. To that end, Congress stipulated that such property would have a basis for income tax purposes in the hands of the heir equal to the value used in determining the originating estate's estate tax – generally, its fair market value.[14]

However one might regard the rationale for this provision, it collapses entirely if no estate tax is paid by the originating estate. In that circumstance, there is no duplicative second layer of taxation, so there is no reason for the inherited property's basis to be stepped up to its fair market value when the decedent dies. More explicitly, a step-up in the basis of an inherited asset is *not* contingent on that asset's actually being subject to the estate tax. As a result, the appreciation in value of inherited assets in this situation escapes both income *and* estate taxation! Moreover, with the increase in the effective estate tax exemption,[15] especially in recent years,[16] the number of estates that owe estate tax has declined precipitously. At the 2021 estate tax exemption level of $11,700,000,[17] less than one out of a thousand decedents will likely owe any estate tax.[18] Accordingly, the double-taxation *raison d'etre* for the step-up-in-basis rule applies in only a tiny minority of circumstances when appreciated property is transferred *post mortem*.

The seriously flawed rationale for this rule is not the only reason it is facing political vulnerability. Its cost in terms of lost federal government revenue loss is considerable: almost $42 billion in lost tax revenue in 2021, according to the widely-respected Joint Committee on Taxation's analysis.[19] At a time of renewed attention to, and sensitivity about, increasing concentrations of wealth in the United States, disparities in the taxation of wealth symbolized by the step-up-in-basis rule

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14 *See id.* § 1014(a).

15 *See id.* § 2010(c)(1)-(2)(A).

16 *See id.* § 2010(c)(3)(C), added by Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11061(a), 113 Stat. 2054, 2091 (2017).

17 Rev. Proc. 2020-45, § 3.41, 2020-46 I.R.B. 1016, 1024.

18 *See* Tax Pol'y Ctr., How Many People Pay the Estate Tax? 3 (2020), https://www.taxpolicycenter.org/sites/default/files/briefing-book/3.12.3.pdf (only 0.07% of decedents in 2019 paid any estate tax).

19 Staff Joint Comm. on Tax'n, JCX-23-20, Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024, at 29 (2020) (available for download at https://www.jct.gov/publications/2020/jcx-23-20/ [https://perma.cc/A5UG-8ESS]).

have made that rule's continuation more problematic with each passing day.

But long before the current focus on economic inequality, the step-up-in-basis rule raised the ire of tax reformers and was actually repealed in the Tax Reform Act of 1976.[20] Instead, the basis of inherited property was determined by a version of the carryover basis rule that applies to *inter vivos* transfers.[21] This legislative change, however, was met with fierce opposition after it was enacted, primarily due to the record-keeping problems associated with reconstructing what long-deceased relatives might have paid for properties that had been passed along through multiple generations.[22] These complaints resonated with lawmakers such that Congress first delayed the effective date of this major change[23] and then repealed the carryover-basis regime in 1980,[24] retroactive to its original enactment date.[25] A similar campaign to alter the step-up-in-basis rule took place during the first year of President Bill Clinton's Administration,[26] but this effort never made it out of Committee.

President George W. Bush, however, did succeed in getting this rule repealed but only for a single taxable year, 2010.[27] This change was made as part of the major tax legislation of his first year in office that also repealed the federal estate tax,[28] though once again, only for a single year. This law acknowledged that without a federal estate tax, the purported rationale of the step-up-in-basis rule was effectively nullified and that rule had to be repealed. In its place, still another variation of carryover basis was enacted for inherited property,[29] but a significant remnant of the step-up-in-basis rule was retained nonetheless. Specifically, $1.3 million of appreciation was allowed to be stepped-up,[30] plus

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20 Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005(a)(2), 90 Stat. 1520, 1872-77.

21 I.R.C. § 1023(a)(1) (repealed 1980).

22 *See* Harry L. Gutman, *Taxing Gains at Death*, 170 TAX NOTES FED. 269, 272 (2021).

23 *See* Revenue Act of 1978, Pub. L. No. 95-600, § 515(3)-(4), 92 Stat. 2763, 2884.

24 Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 401(a), 94 Stat. 229, 299.

25 *See id.* § 401(b), (e), 94 Stat. at 299, 301.

26 *See* Rick Wartzman, *Clinton Suggestion of Possible Capital Gains Tax Upon Death Stirs Ire Among Powerful Interests*, WALL ST. J., Jan. 5, 1993, at A16.

27 *See* Chris Edwards, *Tax Policy Under President Bush*, CATO INST. (Aug. 14, 2006), https://www.cato.org/commentary/tax-policy-under-president-bush [https://perma.cc/FZL6-WWEQ].

28 Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501(a), 115 Stat. 38, 69.

29 I.R.C. § 1022(a)(2), *repealed by* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 301(a), 124 Stat. 3296, 3300.

30 I.R.C. § 1022(b)(1), (2)(B) (repealed 2010).

an additional $3 million for property transferred to a surviving spouse.[31] These allowances recognized that while repealing the estate tax in exchange for no step-up-in-basis rule appealed to taxpayers with considerable wealth that exposed them to the estate tax, the vast majority of property inheritors received a step-up-in-basis without having any estate tax exposure. And those taxpayers – who far outnumbered taxpayers with estate tax exposure – would be losing the benefits of the step-up-in-basis rule without gaining any offsetting estate tax relief. Finally, President Barack Obama also proposed repealing the step-up-in-basis rule,[32] but nothing came from that effort.

President Joseph Biden decided to revisit this rule to raise funds for his ambitious government spending plans and to address the economic disparities that became especially salient during the most recent Presidential election cycle.[33] His revenue proposals for the 2022 fiscal year seek to repeal most of the step-up-in-basis rule[34] without even pretending to eliminate the estate tax. This proposal, in other words, is radically different from President Bush's earlier effort, as described earlier.

President Biden's proposals attempt to effectuate his overriding theme of equalizing the taxation of what he termed "work" and "wealth." To this end, he also proposed taxing long-term capital gains as ordinary income for taxpayers with annual incomes of $1 million or more.[35] But this change, radical though it may be, could be easily avoided by taxpayers choosing not to sell their appreciated property in anticipation of a step-up in basis when they died. To remove this disincentive to realize capital gains during the owners' lifetime, President Biden targeted the step-up-in-basis rule for repeal.

III. What the Rule's Repeal Means Going Forward

The contours of the proposed repeal of the step-up-in-basis rule reflect some of the history recounted above. For example, appreciated property passing at death would be treated as being sold for its fair market value on that date,[36] and the decedent's final income tax return would report the resultant gain or loss.[37] But recognizing the broad im-

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31 *Id.* § 1022(c)(1), (2)(B) (repealed 2010).

32 *See* John D. McKinnon, *Obama Aims to Raise Taxes on Inheritances*, Wall St. J. (Jan. 26, 2015, 2:29 PM), https://www.wsj.com/articles/obama-targets-major-loophole-in-income-tax-code-1422300573 [https://perma.cc/SV7V-42Y5].

33 *See General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*, U.S. Dep't Treasury 61 (May 2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf.

34 *See id.* at 62-63.

35 *Id.* at 62.

36 *Id.*

37 *See id.*

pact such a rule would have on nonwealthy Americans, the Biden Administration has proposed that $1 million of appreciation per person remain eligible for a step-up in basis as under the current law.[38] As a result, the proposal would primarily impact persons with extensive holdings of assets that have increased in value. According to the Federal Reserve Board, more than two-thirds of all American families have unrealized property gains,[39] but the median of such gains for the top decile of American families is only $519,000[40] – well below the proposal's $1 million exclusion.

In determining the proposal's reach, it must be noted that increasing numbers of Americans have the bulk of their financial assets in various tax-favored retirement savings vehicles. These arrangements, which include 401(k) and 403(b) plans sponsored by employers and Individual Retirement Accounts that taxpayers can establish on their own, have never been eligible for a step-up-in-basis,[41] so they would not be affected by the new proposal. In fact, these tax-favored retirement plans would now be on a more equal footing with assets that were previously eligible for a step-up-in-basis and might therefore be more attractive than previously for additional investments. That is, one of the advantages of taxable investments over retirement savings plans is that taxable investments can have their entire appreciation exempted from income taxation by the step-up-in-basis rule, but that advantage would now be largely neutralized, at least for the upper range of investors.

For taxpayers with appreciated assets above the new $1 million allowance for step-up-in-basis treatment, traditional planning strategies might need to be reconsidered. At a minimum, there would not be much incentive to hold such assets until death because the step-up-in-basis that might eliminate income tax liability on their appreciation would no longer be available. Further, the disincentive to make lifetime gifts of such property due to the carryover basis rule when contrasted with a possible step-up-in-basis at death would similarly be eliminated. Accordingly, lifetime gifts might become more appealing to potential donors.

One of the most significant changes if the Biden proposal is enacted would be to further encourage donations of appreciated property to charitable organizations during a donor's lifetime.[42] While donative

38 *See id.* at 63. This threshold would be indexed for inflation after 2022 and would be portable between spouses.

39 Richard Rubin & Rachel Louise Ensign, *Capital-Gains Tax Plan Spurs Concerns*, WALL ST. J., Apr. 20, 2021, at B10.

40 *See id.*

41 *See* I.R.C. §§ 691(a)(1)(B), 1014(c). *See* BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.03[3], at 5-18 (3d ed. 2002).

42 *See* U.S. DEP'T TREASURY, *supra* note 33, at 63.

transfers are almost always motivated by factors other than tax considerations, the prior calculus might have favored giving appreciated property to family members who could receive such assets at the donor's death without any income tax due on that appreciation.[43] But now, such transfers would be treated as taxable dispositions,[44] so charitable transfers would look more appealing by comparison.

On the other hand, the partial preservation of the step-up-in-basis rule would introduce its own complexities and legal issues. During the brief period when the similar partial exclusion was applicable, executors faced the daunting task of apportioning the available exclusion among various legatees.[45] The retention of $1 million of tax-free appreciation, in other words, would require executors of estates with appreciation exceeding that threshold to determine which appreciated assets would go to which heirs and whether to consider the individual tax circumstances of those heirs. Some executors might ignore these basis considerations, while others might try to minimize the tax liability of the recipients as a group.

At the same time, the demise of the step-up-in-basis rule might resurrect certain issues that the step-up-in-basis rule made less important. For example, if an appreciated asset is illiquid, how would a decedent pay the income tax now owed upon its constructive disposition?[46] To be sure, taxation has never been terribly concerned about matters of liquidity in assessing whether taxes are owing, and even now, a decedent could avoid this dilemma by simply selling some of the appreciated assets prior to his or her death. In addition, borrowing funds to pay the taxes now owed could be considered.

Still another practical issue that the step-up-in-basis rule obviated is the need to determine the decedent's basis in the appreciated property owned at death. It would now be necessary to determine this amount so that the unrealized gain or loss can be calculated. Over time, of course, this problem would likely dissipate as property owners realize that records of such basis will be needed to prepare one's final tax return, but until then, property owners - or more likely, their estates' executors - would need to do some serious detective work, possibly extending over more than one generation, to derive defensible basis computations.[47]

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43 *Id.* at 61.

44 *See id.* at 62.

45 *See, e.g.*, Justin P. Ransome & Frances Schafer, *Estate Tax or Carryover Basis?*, J. ACCT., July 2011, at 29, 29-30. *But see* Jonathan Curry, *Estate Planners Better Prepared to Track Basis if Needed*, 171 TAX NOTES FED. 1816, 1816 (2021).

46 *See* U.S. DEP'T TREASURY, *supra* note 33, at 63 (appreciation of family-owned and -operated businesses would not be taxed until that status no longer applies).

47 *See* Treas. Reg. § 1.1015-1(a)(3) (1971).

IV. Conclusion

Very few tax rules have persisted largely intact for an entire century, and when such a rule is eliminated for many taxpayers, the changes in taxpayer behavior are likely to be dramatic. Such would be the case if the tax code's step-up-in-basis rule for inherited property is significantly curtailed. Owners of appreciated property beyond the permitted exclusion amount would probably reevaluate their plans for lifetime versus testamentary gifts, allocations to retirement savings plans, and intended charitable contributions.