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ACCUMULATE WEALTH AND REDUCE TAXES

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Understanding the Step-Up In Basis Rule

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Highly appreciated assets require special consideration in your estate plan. The step-up in basis rule states that inherited property assumes a basis equivalent to its fair market value at the date of the decedent's death. It is referred to as a "step-up" because frequently the fair market value of the property at the date of death is greater than the decedent's basis i.e., its cost when it was first acquired. (Similarly, if the fair market value of the property is less than the decedent's basis, there is "step down.")

Bequeathing highly appreciated assets is an effective way to avoid paying capital gains taxes. However, there is a restriction: you cannot give property to someone facing imminent death, and expect that the property will be returned to you with the new "stepped-up" basis. The law prevents the step-up in basis if the individual who receives the gift dies within one year and the property returns to the original owner or his/her spouse.

The step-up in basis can provide legitimate tax savings for your heirs. Trying to capitalize on the rule to save taxes by shifting ownership of jointly held property carries inherent risks, some of which we discuss below.

Basic Step-Up In Basis Rules

Assume there is a parcel of vacant land that Tom the Taxpayer has purchased for investment. Tom bought the land for $10,000 in 1980. The parcel would now sell for $100,000 after costs and commissions. If Tom sold the parcel tomorrow, he would have to pay $18,000 in federal income taxes on the $90,000 capital gain.

$100,000 (net proceeds) - $10,000 (cost basis) = $90,000 (capital gain)

$90,000 (capital gain) x 20 percent (tax rate) = $18,000 (federal income taxes)

Now assume that instead of selling the land, Tom holds the property. Tom dies leaving the land to his child through his will. Then, assume the child sells the property the day after Tom dies. What is the gain to the child?

If you said $90,000 capital gain and $18,000 tax, you're thinking logically, but your answer is

wrong. The right answer is, *the child would pay no income taxes*. The child's basis becomes the fair market value of the land at Tom's date of death. Since the value of the property is $100,000 on the date of death, and Tom's son sold the land for $100,000, he would pay no capital gains tax because of the step-up in basis rule. Thank you, Uncle Sam.

Step-Up In Basis for Jointly Owned Property Between Husband and Wife

Let's look at a different scenario. Assume Tom bought the property in 1980 for $10,000 and in 1986 transferred it to jointly held property with his wife. Then, Tom dies and his wife receives the property by operation of law because she is the surviving joint owner. Assuming that the property was included in Tom's estate there would be no estate tax because of the unlimited marital deduction. However, when Tom's wife sells the property for $100,000 she is subject to a taxable gain.

Tom's wife would be able to claim a step-up in basis on one half of the property.
Her gain would be $45,000 calculated as follows:

$10,000 (original basis) ÷2 = $5,000 (wife's share of basis after joint ownership) +
$100,000 (fair market value at date of death) ÷2 = $50,000

Total basis is $55,000

$100,000 (total proceeds) - $55,000 (total basis) = $45,000 (taxable gain)

$45,000 (taxable gain) x 20 percent (tax rate) = $9,000 (federal income taxes)

Currently in Pennsylvania, there is no way to avoid the capital gains taxes in the above transaction if the property remains in joint ownership. Are there any other available options? Consider the following scenario: Tom's health is failing, so he and his wife decide to transfer the property to Tom. If he survives one year, and leaves the property to his wife, his wife will then have the benefit of a full step-up in basis. Potentially it is a great idea. However, if we guess wrong, and Tom's wife dies first, then Tom loses the half-step-up in basis that he would have received had the property remained jointly owned. Once Tom is the sole owner if he needs to sell or transfer the money after his wife dies but before he dies, he will receive no step-up in basis. The risk may be too great.

Pennsylvania is a *"non-community"* property state. In community property states owners of community property (i.e., all property a married couple acquires during the marriage other than by gifts or inheritances) get a *full step-up in basis* when the first partner dies. Only eight states are community property states. However, if you want to protect your highly appreciated assets for your spouse, there is a sly alternative. Alaska has set up a deal where you can transfer assets into an Alaskan trust and by law, it is community property with a situs in Alaska, even though *you* reside elsewhere. Your only contact with Alaska is that the funds are managed by an Alas-

kan trust company or bank. Then, upon the first death, your spouse gets a complete step-up in basis. While this might seem extreme, it is worth considering in some circumstances, for example:

Tom and Mary, a married couple are both frail with uncertain, but not long life expectancies. They have sufficient assets that their estate plan incorporates transfers and/or sales, both during their lives and after their deaths. If their highly appreciated assets stay in a jointly held account, and one dies, the survivor will receive a one half step-up in basis. If they guess right and transfer the assets to the spouse who dies first, there will be an entire step-up in basis. If they guess wrong and transfer the property to the spouse who survives, there will be no step-up in basis for the survivor.

Since transfers and/or sales are anticipated between the first and second death, it would be beneficial for the survivor and the family to achieve a full step-up in basis on the property after the first death no matter which spouse dies first. To accomplish this, the property is transferred to Alaska in a qualifying account. After the first death, the entire property receives a full step-up in basis. Getting a step-up in basis for property that will then be transferred to the kids or to a family limited partnership *between the first and second death* could be advantageous. For a smaller estate without significantly appreciated assets, it is probably not worth the aggravation and fees. For a large estate, with appreciable capital gains tax exposure, the fees for setting this up could be trivial compared to the savings in income taxes for either the surviving spouse or the eventual heirs.

Contact Information

Jim is a tax attorney and CPA who provides specialized retirement and estate planning services to individuals with significant retirement plan accumulations. He has prepared over 400 simple and complex retirement and estate plans for individuals with significant retirement assets. These plans include tax-savvy advice, will and trust preparation, and sophisticated beneficiary designations for IRAs and other retirement plans.