Step-Up in Tax Basis or Step-Down?

Craig R. Hersch, Florida Bar Board Certified Wills, Trusts & Estates Attorney, CPA

Will the proposed tax legislation currently before Congress eliminate the step-up in tax cost basis? What exactly do I mean when I refer to a step-up?

If I buy a stock for $1/share and it is now $51 share, if I sell that stock, I realize a $50/share capital gain. Under our Internal Revenue Code (IRC), I'm taxed on that gain, which is the difference between the sales price and my tax cost basis – the amount that it cost me to purchase the shares.

If I don't sell those shares before my death, and then those shares are bequeathed to my daughter, she receives a "step-up" equal to the fair market value of those shares at the time of my death. Assume that the value is $51/share. My daughter then sells the shares for $52. She only realizes a $1 capital gain, so her capital gains tax is much lower than what I would have realized had I sold the shares at my death.

What about depreciable assets, such as a commercial building? Suppose I paid $100,000 for a building and added a structure that cost me $300,000. My tax cost basis is $400,000. Over the years I depreciated that building. During that time, I was able to expense $250,000 of depreciation, charging it against my income, which lowered the amount of income tax I would pay. My tax cost basis is now $150,000.

If I sell the building for $500,000 my realized capital gain is $350,000, which represents the difference between the sales price of $500,000 and my depreciated tax cost basis of $150,000. What if I die before I sell the building, and my daughter inherits it? She gets a step-up in tax cost basis equal to its current fair market value ($500,000) and gets to depreciate it all over again!

This step-up in tax cost basis is valuable to anyone who inherits assets whose value is more than the decedent owner's basis. If a new law were to strike down this feature, it would result in higher capital gains taxes for nearly everyone who inherits stocks, mutual funds, homes, and buildings. I should note that certain assets don't receive a basis step-up, including annuities and tax-deferred retirement accounts, such as IRA and 401k accounts.

It's important to understand that that the law doesn't just adjust tax basis upward, despite its common name, "step-up."

The law could result in a step-down because the applicable IRC Section 1014 states, "...the basis of property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be – the fair market value of the property at the date of decedent's death."

If, for example, I purchased shares of a company at $100/share, and at the time of my death the value is only $25/share, my daughter inherits those shares with a tax cost basis equal to the fair market value at the time of my death. If she later sells them at $25/share, she recognizes no capital loss. Had I sold the shares before my death, I would have realized a $75 capital loss that I could have used to offset capital gains that I realized.

What if I don't know what my tax cost basis in an asset is? Suppose that I sell shares of stock at $100/share but can't find documentation as to what my basis is. The IRS assumes that my basis is zero!

Consequently, if I sell the shares, I realize a capital gain equal to the entire sales price! This rule could pose significant problems for anyone inheriting property should the adjustment to fair market value under IRC section 1014 be eliminated. If my daughter can't find records justifying my basis, any asset of mine that she sells would result in a realization of the entire sales price as capital gain, even if it would have been a loss to me!

How often might beneficiaries not be able to document the basis of inherited assets? I believe more frequently than not, resulting in a potential windfall to the IRS.

Talk about a blow to the middle class. The elimination of this law doesn't just affect the wealthy. It affects anyone who inherits assets. It certainly benefits those inheriting millions more than those inheriting a few thousand dollars, but the effect on the less wealthy recipients seems to hit harder. They need the money more, yet they still pay capital gains taxes when liquidating inherited property.

Here's the good news – at least hopeful news: In my 31+ years practicing estate planning law, Congress has from time to time considered eliminating the step-up. It hasn't happened. Maybe it won't happen now.

We can only wait and see.

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Craig R. Hersch is a Florida Bar Board Certified Wills, Trusts & Estates attorney and holds his Florida CPA license, with over 30 years of experience in his practice. Craig is a partner at Sheppard, Brett, Stewart, Hersch, Kinsey & Hill and has created several trademarked processes tied to his estate planning and administration practice, including The Family Estate & Legacy Program and The Estate Settlement Program.

Craig has authored six books for clients: The Florida Estate Planning Guide, Selecting Your Trustee, Common Cents Estate Planning, Legal Matters When a Loved One Dies, Asset Alignment and Your Estate Plan and Common Cents Estate Planning II. His work has appeared in several professional journals, including The Practical Tax Lawyer, and The Florida Bar Journal, as well as being on the editorial advisory board for Trusts & Estates Magazine, the premier trade journal for estate planning attorneys, CPA's, and financial advisors. Craig also writes a weekly estate planning column that is published in Sanibel's Island Sun newspaper and on his firm's blog.

Craig is a multiple graduate of the University of Florida with accounting and law degrees and has provided his expertise as a continuing education lecturer for The Florida Bar and the Florida Institute of Certified Public Accountants.

Craig holds an AV Martindale Hubbell rating, the highest attainable by the independent national attorney rating service, has been selected as a Worth 100 Top Attorney and has been named to the Super Lawyers list every year since 2009, a highly-esteemed recognition given to no more than five percent of attorneys in Florida.

During his free time, Craig enjoys competing in triathlons, having finished an Ironman distance race and seven half-Ironman races over the last decade. Craig is married to his wife, Patti, and they have three daughters: Gabrielle, Courtney, and Madison.

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Michael B. Hill is a partner at Sheppard Law Firm. Michael is a Florida Board Certified Will, Trusts & Estates attorney concentrating his practice in estate and wealth preservation and business succession planning.

Michael has extensive tax, legal and technology skills, enabling him to create unique plans for meeting client's individual and family needs.

Michael is a double graduate of the University of Florida, receiving his Bachelor of Science in Accounting in 1998, and his Juris Doctor, with honors, in 2001. He is a member of the Florida Bar Association, the American Bar Association, and the Lee County Bar Association.

Michael and his wife, Jamie, have four children, Connor, Chase, Lindsay, and Caleb. In his free time, when there is any, Michael enjoys playing golf, working out, and watching most Gator sports. As an alumnus of the Fightin' Gator Marching Band, you may be able to spot him on Florida Field as a member of the Alumni Band, which marches at one home football game each year.

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Hayley E. Donaldson has been recently promoted to partner with the Sheppard Law Firm, working closely with estate planning attorneys Craig R. Hersch and Michael B. Hill.
Hayley helps guide family members in the trust administration and probate process after the passing of their loved one.

Additionally, she assists clients with their tax and estate planning, drafting simple and complex wills, trusts, and related estate planning documents. Hayley received her Juris Doctor from the University of Florida Levin College of Law, graduating first in her class. In law school she was a member of the Florida Law Review and Volunteer Income Tax Assistance (VITA) program which assists lower income individuals with their yearly tax returns.

Hayley is also a Certified Public Accountant (CPA) and worked previously as an Internal Audit Consultant for a national firm. Hayley has a Masters in Professional Accounting from the University of Texas and holds degrees in Accounting and Finance from the University of Miami. Raised in Fort Myers, she is also a proud graduate of the International Baccalaureate program at Fort Myers High School.

In her free time, Hayley enjoys running, swimming, and watching the Boston Red Sox.

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Andrew is an associate of Sheppard Law Firm, works closely with estate planning attorneys Craig R. Hersch and Michael B. Hill. Andrew assists clients with their tax and estate planning, drafting simple and complex wills, trusts, and related estate planning documents.

Andrew holds Bachelor of Science from Virginia Commonwealth University and Juris Doctor degree from the St. Thomas University School of Law. His non-legal experiences includes work in the real estate industry as a licensed Realtor and appraiser.

Andrew also worked as a regulator analyst for Dominion Energy where he administered contracts that connected generating facilities to the electric system.
Andrew served as an Assistant State Attorney in southwest Florida before transitioning into a general trial practice concentrating on civil litigation and personal injury lawsuits.

Andrew is a member of the Florida Bar Association, and is also admitted to practice in the U.S. District Court, Middle District of Florida.

Andrew is married to Jennifer, who practices criminal law in southwest Florida. In his spare time, Andrew enjoys exercising, fishing, home improvement projects, and spending time with his family.