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Obama Takes Aim at ‘Step Up’ Tax Break on Inherited Assets

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President Obama’s proposal to impose capital-gains tax on many inherited assets would curtail a valuable tax benefit known as the “step up” in basis.

Here’s how the Journal explained the step-up benefit in a recent Weekend Investor cover story:

> *The federal code has long had a provision, known as the “step up,” that cancels the long-term capital-gains tax on assets that a taxpayer holds until death. The step-up automatically raises the owner’s cost basis for such assets—the starting point for measuring a taxable gain—to its full market value as of the date of death.*

> *For example, say an investor bought a piece of land or stock shares many years ago for $20,000, and the value has grown to $200,000. If the investor sells the asset before his death, he will owe capital-gains tax on the $180,000 profit, at a rate as high as 23.8%—the 20% top rate on long-term gains, plus a surtax of 3.8% levied on higher-income taxpayers.*

> *If the investor holds the same asset until death, however, the capital-gains tax vanishes. The asset will be included in the owner’s estate at full market value, where the exemption of more than $5 million per person could shelter it from federal estate tax as well.*

President Obama’s proposal, as outlined in a White House fact sheet, is to treat bequests other than to charitable organizations as potentially taxable, just like other instances in which assets change hands. There would be a few exceptions: For couples, it says, tax wouldn’t be due until the death of the second spouse. Gains of up to $100,000 per individual (or $200,000 per couple) could still be left to heirs free of tax—in addition to an exemption of up to $250,000 per individual (or $500,000 for a couple) for a home.

The White House fact sheet also says: "No tax would be due on inherited small, family-owned and operated businesses —unless and until the business was sold."

Minimizing capital-gains taxes has become a key focus of estate planning for many families in recent years, since Congress raised the federal estate-tax exemption amount, shielding many estates from that tax, the recent Weekend Investor story explained. (This year, the estate-tax exemption is $5.43 million per individual and double that for a married couple.) Here's an example from that article:

> *The new focus on the step-up prompted Ren Grevatt, now 94 years old, to do an about-face in his estate plan. For years, says his son Jonathan, who helps his father with his affairs, planners suggested that the father give his children the family's beloved seven-bedroom Vermont farmhouse to avoid estate taxes that could have forced a sale.*
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> *Now Mr. Grevatt plans to keep the house until he dies. He and his 87-year-old wife, who live in New Jersey, bought it for less than $100,000 in the 1960s, shortly before he became a publicist for such rock groups as the Beatles, the Rolling Stones, Led Zeppelin and the Who. The house, which is in prime ski country with views of two lakes, has appreciated greatly.*
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> *As the parents' estates will total less than $10 million together, no federal estate tax will be due. By holding on to the house, however, the parents will enable their children to inherit the property at its current market value—and skip capital-gains tax of up to 23.8% on decades of appreciation.*
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> *"I'm glad my father didn't get around to giving us the house," says the younger Mr. Grevatt.*
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> *Experts recommend scrutinizing which assets to hold until death to maximize the step-up. This move is especially important in high-tax states such as California, where the top combined federal and state capital-gains rate exceeds 35%.*

In addition, a little-noticed feature of the White House proposal would change the taxation of gifts made during one's lifetime.

Under current law, no income tax is due on such gifts. (If the gift is more than $14,000 per year to a single individual, the excess is deducted from the giver's lifetime gift- and estate-tax exemption of $5.43 million per individual.)

For gifts of noncash assets, however, the giver's cost basis does "carry over" to the recipient. So if a grandmother gives her granddaughter $14,000 of stock that was acquired for $2,000, then when the granddaughter sells the stock she will owe tax on the gain above $2,000. That sale might not be for many years.

Under the Obama proposal, such gifts made during one's lifetime would trigger capital-gains tax. The proposal doesn't say whether the giver or the recipient would pay the tax. Beth Kaufman, a lawyer with Caplin & Drysdale in Washington, speculates that the giver would bear the tax, and the recipient would receive an asset with a cost basis of current market value.

The answer to another important issue for wealthy people is unclear, based on the description in the president's proposals, she says. Namely, would the capital-gains tax imposed at death be deductible from the estate tax? If it isn't, she notes, then the combined federal capital-gains and estate-tax rate at death would be 68%—plus any state levies due.