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The Trade-offs of Repealing Step-Up in Basis

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Key Findings

- The cost basis of property transferred at death receives a "step-up" in basis to its fair market value. This eliminates an heir's capital gains tax liability on appreciation in the property's value that occurred during the decedent's lifetime.

- Property transferred before death receives "carryover basis," which means the donor's original cost basis is carried over to the recipient. This requires recipients to pay capital gains taxes on appreciation in the property's value that occurred during the donor's lifetime if they sell the property.

- Step-up in basis discourages people from realizing capital gains. Eliminating the policy would encourage capital gains realization, increase federal revenue, and remove a tax expenditure that allows taxpayers to entirely exclude returns on saving from taxation.

- Step-up in basis can reduce compliance costs for heirs because tracking cost basis of long-held assets, especially from decedents, can be difficult. Step-up in basis could also shield heirs from paying both estate and capital gains taxes on the same asset.

- Repealing step-up in basis would make the tax code more neutral and eliminate a tax expenditure. But eliminating the policy without changing the estate tax could increase the tax burden on capital and increase compliance burdens for taxpayers.

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Introduction

When a person leaves property to an heir, the cost basis of the bequeathed asset receives a "step-up" in basis to its fair market value at the time of the original owner's death. Step-up in basis reduces capital gains tax liability on property passed to an heir by excluding any appreciation in the property's value that occurred during the decedent's lifetime from taxation.[1]

This policy has been critiqued for its "lock-in effect," that it discourages taxpayers from realizing capital gains by allowing a deceased person's returns from saving, in the form of capital gains, to be passed on to heirs without tax. This reduces federal revenue and benefits mainly high-income taxpayers.[2]

Yet, step-up in basis could also keep heirs from paying both the estate tax and capital gains tax on the same asset. In other words, step-up in basis protects capital from double taxation.[3] The policy also reduces compliance costs for taxpayers, largely because proving the original cost basis of a deceased person's asset can be difficult.[4]

This analysis explains how step-up in basis works, focusing particularly on how the provision interacts with the estate tax. It discusses the considerations before policymakers when evaluating this possible policy change. In deciding whether to repeal step-up in basis, policymakers must confront several trade-offs. Eliminating step-up in basis would make the tax code more neutral and remove a tax expenditure that primarily benefits wealthy taxpayers. But eliminating step-up in basis without changing the estate tax would increase the tax burden on capital and compliance burdens for taxpayers.

1 26 USC § 1014. See also "Income tax basis in property received," in "Part VI: Increase in Estate and Gift Tax Exemption," in Joint Committee on Taxation, "General Explanation of Public Law 115-97," Dec. 20, 2018, https://www.jct.gov/publications.html?func=startdown&id=5152.

2 See "Exclusion of Capital Gains at Death; Carryover Basis of Capital Gains on Gifts," in Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions," Congressional Research Service, December 2012, https://www.govinfo.gov/content/pkg/CPRT-112SPRT77698/pdf/CPRT-112SPRT77698.pdf, as well as Option 74: "End stepped-up basis of capital gains at death," in *Options for Reforming America's Tax Code* (Washington, D.C.: Tax Foundation, 2016), https://files.taxfoundation.org/20170130145208/TF_Options_for_Reforming_Americas_Tax_Code.pdf.

3 Stephen J. Entin, "The President Proposes a Second Tax on Estates," Tax Foundation, Jan. 23, 2015, https://taxfoundation.org/president-proposes-second-tax-estates/.

4 Option 74: "End stepped-up basis of capital gains at death," in *Options for Reforming America's Tax Code*.

Background on the Estate Tax and Step-Up in Basis

The Estate Tax

Each year, the estate tax impacts a small subset of taxpayers that transfer wealth to heirs at death[5] and generates little revenue compared to other taxes. In 2017, the number of taxable estate tax returns filed was 5,185,[6] compared to the more than 153 million individual income tax returns.[7] Estate and gift taxes combined—which tax financial and physical assets such as real estate, securities, and cash[8]—accounted for less than 0.7 percent of federal revenue in 2017, compared to almost 48 percent for individual income taxes.[9]

Taxpayers can reduce the amount of their taxable estate with several deductions, such as donations made to charitable organizations as well as funeral expenses. Taxpayers can also use a large exemption (known as the "unified credit") to exclude a portion, or oftentimes all, of their taxable estate from the estate tax.[10] In 2019, the first $11.18 million of an individual's estate is exempt from taxation ($22.36 million for married filers).[11] Any taxable value beyond deductions and the exemption is taxed at a rate of 40 percent, meaning the estate tax takes $0.40 of every dollar of taxable value beyond the exemption.[12]

Step-Up in Basis

Currently, whenever any property is transferred from a decedent to an heir at the time of death, the basis of capital gains for that piece of property is stepped up to current fair market value. Step-up in basis reduces capital gains tax liability on property passed to an heir by excluding any appreciation in the property's value that occurred during the decedent's lifetime from taxation. If the heir decides to sell this property immediately upon transfer, no capital gains tax would be owed. If the heir decides to hold on to the property and sell in the future, any capital gain would be measured against the heir's new stepped-up basis, and the gain would be taxed at the heir's applicable capital gains tax rate. Importantly, the heir doesn't have to realize the capital gain at all. Instead, the heir could keep the property until death and give the property to a new heir, at which time the property would take

5 26 USC § 2001-2210. For information on the declining number of taxpayers subject to the estate tax, see "Table 2. - Number of Taxable Estate Tax returns Filed as a Percentage of Deaths, Selected Years, 1935-2013," in Joint Committee on Taxation's "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," March 16, 2015, https://www.jct.gov/publications.html?func=startdown&id=4744.

6 Internal Revenue Service, "SOI Tax Stats - Estate Tax Statistics Filing Year Table 1," 2017 data, https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics-filing-year-table-1.

7 Internal Revenue Service, SOI Tax Stats - Individual Income Tax Returns, Preliminary Data, "Table 1—Individual Income Tax Returns: Selected Income and Tax Items," 2017 data, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns#prelim.

8 Internal Revenue Service, "Estate Tax," https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax. See also Alan Cole, "Modeling the Estate Tax Proposals of 2016," Tax Foundation, June 14, 2016, https://taxfoundation.org/modeling-estate-tax-proposals-2016.

9 Scott Eastman, "New IRS Data Reiterates Shortcomings of the Estate Tax," Tax Foundation, Oct. 18, 2018, https://taxfoundation.org/new-irs-data-reiterates-shortcomings-estate-tax/.

10 The estate tax's exemption is called the unified credit because it is shared with the gift tax. The credit is unified because amounts used to offset the gift tax cannot be used to offset estate tax liability at death. The estate and gift taxes also share the same rate schedule and other features. See "Section III. B—Common Features of the Estate, Gift and Generation Skipping Transfer Taxes," in Joint Committee on Taxation's "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System."

11 For tax years 2018 through 2025, the TCJA doubled the estate and gift tax exemptions. These provisions are also indexed for inflation occurring after 2011. See "Explanation of Provision," in Joint Committee on Taxation, "General Explanation of Public Law 115-97," 89.

12 The estate tax has a progressive rate schedule, with the lowest rate beginning at 18 percent for estates valued between 0 and $10,000, going up to a top marginal rate of 40 percent for estates valued at more than $1 million. But due to the size of the unified credit, estates face a functionally flat tax rate of 40 percent for every dollar beyond the exemption. For the rate schedule, see 26 USC § 2001 (C). For Basic Exclusion Amount, see 26 USC § 2010 (C) (3).

another step-up in basis to its fair market value, and the process would begin again.[13]

Step-up in basis differs from the treatment of cost basis applied to transfers of property before death. Property transferred before death receives "carryover basis," and the donor's original cost basis in any property is transferred to the recipient of the property.[14] Like step-up in basis, the recipient is liable for capital gains taxes only when the property is sold, but upon sale, the capital gain will most likely be larger, resulting in a higher capital gains tax liability. This is because, under carryover basis, any appreciation in the property's value from the time the donor acquired the property to the time the donor transferred the property to the recipient is taxable. Recipients of gifts transferred before death can also defer capital gains until their own death, in which case the capital gains would receive step-up in basis when transferred to an heir in an estate.[15]

The Impact of Step-up in Basis

To see the potential difference in tax liability between step-up in basis and carryover basis, assume that a person owns a single asset with a value of $6 million in 2019, and that the original cost basis of this asset was $2.5 million.

If this property is transferred to an heir after death via an estate, step-up in basis would apply and the cost basis of the capital gain would be increased to its fair market value. If this property were sold immediately by the heir upon transfer, step-up in basis would eliminate capital gains tax liability (see Table 1). The heir could also decide to hold on to the property. If the heir sells the property in the future, the basis of the capital gain would be $6 million, instead of the decedent's original cost basis of $2.5 million. The heir could also hold on until death and transfer the property in her estate with step-up in basis.

If the property was transferred before death, carryover basis would apply, and the recipient's cost basis would be the same as the transferor's original cost basis. If the recipient sold the property immediately upon receipt, at $6 million, the recipient would pay capital gains tax on the $3.5 million capital gain. This capital gains income would be subject to a 23.8 percent tax rate (the top, 20 percent rate for capital gains income, and the 3.8 percent net investment income tax).[16] This means the recipient would owe $833,000 in capital gains taxes. If the recipient does not sell immediately, any capital gain in the future would be measured from the donor's original cost basis. In other words, the $3.5 million appreciation that occurred between the donor's acquisition of the property and transfer to the recipient, as well as any appreciation that occurs after that transfer of the capital gain to the recipient, would be taxed at the recipient's applicable capital gains tax rate (in this case, 23.8 percent).

13 26 USC § 1014. See also "Exclusion of Capital Gains at Death; Carryover Basis of Capital Gains on Gifts," in Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions."

14 26 USC § 1015.

15 See "Exclusion of Capital Gains at Death; Carryover Basis of Capital Gains on Gifts," in Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions."

16 In 2019, capital gains for individual taxpayers will be taxed at 0 percent if an individual's income is below $39,375; 15 percent if an individual's income is between $39,375 and $434,550; and 20 percent if an individual's income is above $434,550. See Amir El-Sibaie, "2019 Tax Brackets," Tax Foundation, Nov. 28, 2018, https://taxfoundation.org/2019-tax-brackets/. Individuals with income above $200,000 ($250,000 for married filers) are subject to an additional 3.8 percent tax on their net investment income. See Internal Revenue Service, "Questions and Answers on the Net Investment Income Tax," June 18, 2018, https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax.

TABLE 1.

Capital Gains Tax Liability on Asset Sold Immediately with Step-Up in Basis

Value of Capital Gains at Time of Acquisition	$2.5 million
Value at Time of Death	$6 million
Capital Gain Under Step-up in Basis	$0
Capital Gains Tax Rate:	23.8%
Capital Gains Tax Due:	$0

Source: Author's calculations

TABLE 2.

Capital Gains Tax Liability on Asset Sold Immediately with Carryover Basis

Value of Capital Gains at Time of Acquisition	$2.5 million
Value at Time of Death	$6 million
Capital Gain Under Carryover Basis	$3.5 million
Capital Gains Tax Rate:	23.8%
Capital Gains Tax Due:	$833,000

Source: Author's calculations

Overall, Tables 1 and 2 demonstrate the potentially significant difference in capital gains tax liability between step-up in basis and carryover basis. This difference provides an incentive to pass on property at death through an estate, instead of passing along property before death.

Step-up in Basis is a Nonneutral Tax Expenditure that Discourages Capital Gain Realizations

A tax expenditure is a deviation from the "normal" tax code that lessens a taxpayer's tax burden. Currently, when defining whether a policy is a tax expenditure, the federal tax code relies heavily on the Haig-Simons definition of income, which defines income as equal to the sum of your consumption plus your change in net worth.[17] Under the current system, both step-up in basis and carryover basis are defined by the Joint Committee on Taxation (JCT) as tax expenditures, reducing federal revenue between fiscal years 2018 and 2022 by an estimated $204.4 billion and $9.7 billion, respectively.[18]

Defining a tax base matters when thinking about a tax expenditure. The federal government's current tax base is less than ideal because it taxes delayed consumption, or saving, more heavily than immediate consumption, which reduces after-tax returns on saving and investment.[19] On the other hand, a consumption tax base, which taxes an individual's income but allows an individual's net saving to be deducted from their taxable income,[20] taxes each dollar once, regardless of whether it

17 Robert Bellafiore, "Tax Expenditures Before and After the Tax Cuts and Jobs Act," Tax Foundation, Dec. 18, 2018, https://taxfoundation.org/tax-expenditures-pre-post-tcja/.

18 Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2018-2022," Oct. 4, 2018, https://www.jct.gov/publications.html?id=5148&func=startdown.

19 Ibid. See section "What is the Normal Tax Code?"

20 Robert Carroll, David Joulfaian, and James Mackie, "Income Versus Consumption Tax Baselines for Tax Expenditures," *National Tax Journal* 64, no. 2, Part 2 (June 2011), 491-510, http://www.ntanet.org/NTJ/64/2/ntj-v64n02p491-510-income-versus-consumption-tax.pdf?v=%CE%B1.

is consumed immediately or saved for future consumption. When a dollar is taxed more than once, neutrality is violated. But neutrality is also violated when income escapes taxation entirely, as is the case with employer-provided health insurance.[21]

Step-up in basis would be a tax expenditure under a consumption tax base. This is because step-up in basis would allow the returns from a decedent's saving to escape tax completely, so long as the asset is passed to an heir. Carryover basis would not be a tax expenditure under a consumption tax base. While it's possible for a gift recipient to defer capital gains under carryover basis, these returns to saving will eventually be taxed when the recipient of the gift realizes the capital gain. This recipient would be able to avoid capital gains tax by transferring to an heir at his own death, but in this case, step-up in basis would take effect.

This lock-in effect reduces federal revenue and primarily benefits wealthier taxpayers. Wealthier taxpayers are generally in a better position to pass property on at death than less wealthy taxpayers, who must spend down resources in retirement.[22] Step-up in basis has also been criticized on the grounds that its lock-in effect deters taxpayers from reinvesting capital gains earnings in other areas of the economy.[23] The importance of eliminating step-up in basis as a way to spur U.S. investment is overstated. The U.S. is an open economy with access to a large amount of global saving and doesn't need to rely solely on U.S. saving to fund investment opportunities.[24] In fact, eliminating step-up in basis would likely reduce the incentive to save as it would increase the marginal effective tax rate on saving in the U.S.

Repealing Step-up in Basis Without Changes to the Estate Tax Could Increase Taxes on Capital and Compliance Burdens

Although step-up in basis deserves skepticism as a nonneutral tax expenditure that reduces revenue and primarily benefits wealthy taxpayers, it also mitigates the double taxation of investment income and the economic harm produced by the estate tax. Step-up in basis also makes life simpler for taxpayers that receive property in an estate.

While the estate tax raises little revenue it is harmful from an economic point of view because it discourages saving.[25] This is because the estate tax's 40 percent tax rate allows taxpayers to keep just 60 cents of every dollar above the exemption.[26] Moreover, the estate tax is a third, or even fourth, layer of tax on a given dollar of income, after individual income taxes, corporate income taxes, and other types of taxes paid over a person's lifetime.[27]

21 For instance, the tax treatment of savings vehicles like the 401(k) or the Roth Individual Retirement Account (IRA) are both neutral. In a 401(k), taxation is deferred until savings are withdrawn, and all returns are taxed, whereas after-tax income is invested in Roth IRAs and any returns are withdrawn tax-free. See Erica York, "The Complicated Taxation of America's Retirement Accounts," Tax Foundation, May 22, 2018, https://taxfoundation.org/retirement-accounts-taxation/.

22 See "Exclusion of Capital Gains at Death; Carryover Basis of Capital Gains on Gifts," in Committee on the Budget, United States Senate, "Tax Expenditures: Compendium of Background Material on Individual Provisions."

23 Ibid.

24 Kyle Pomerleau, "Economic and Budgetary Impact of Indexing Capital Gains to Inflation," Tax Foundation, Sep. 4, 2018, https://taxfoundation.org/economic-budget-impact-indexing-capital-gains-inflation/.

25 See "Chapter 3: Estate and Gift Taxes," in *Options for Reforming America's Tax Code*.

26 For context, the top marginal income tax rate for individuals is 37 percent for those earning more than $510,300 in 2019. See Amir El-Sibaie, "2019 Tax Brackets," Tax Foundation.

27 See Alan Cole, "Modeling the Estate Tax Proposals of 2016," Tax Foundation.

Step-up in basis removes one layer of tax on transferred property for heirs by eliminating taxation on any appreciation that occurred during the decedent's life. This makes sure property transferred to heirs is not subject to an estate tax on the total value of an estate's property, as well as capital gains taxes on any appreciation within the property's assets. In a sense, step-up in basis mitigates what would otherwise be a significant effective tax rate on saving.

It's worth noting that estates that currently fall below the estate tax's exemption are spared from the estate tax and the heirs who receive this property are spared from capital gains tax by step-up in basis. In this case, the revenue foregone from step-up in basis doesn't mitigate the effect of the estate tax on investment—it provides an additional tax preference for capital gains income for taxpayers with estates that are not hit by the estate tax.[28]

There is also an administrative argument for step-up in basis. If the policy were eliminated, taxpayers would have to verify the original cost basis of every capital gain to ensure they are compliant. This is often difficult when a donor is living but could be next to impossible for an heir if a decedent did not leave proper documentation of an asset's original cost basis. Eliminating step-up in basis could increase compliance costs for taxpayers.[29]

Conclusion

Repealing step-up in basis for capital gains—which increases the basis of any capital gain transferred to an heir after death to its fair market value—is a difficult call for policymakers. On the one hand, eliminating step-up in basis removes a nonneutral tax expenditure that reduces federal revenue and primarily benefits wealthy taxpayers. But on the other hand, eliminating step-up in basis without changing the estate tax would increase the tax burden on investment and could reduce the size of the economy. Eliminating step-up in basis would also increase the compliance burden for heirs, who would have to verify the original cost basis of property upon a decedent's death. Policymakers should consider these trade-offs when they think about repealing step-up in basis.

28 Steve Entin, "The President Proposes a Second Tax on Estates," Tax Foundation.

29 Option 74, "End stepped-up basis of capital gains at death," in *Options for Reforming America's Tax Code*.