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Income Tax Basis: The Forgotten Concept

The drive to repeal the federal estate tax and the generation skipping transfer tax (GSTT) almost totally ignored the matter of income tax basis until recently. Ironically, for more than 98 percent of U.S. citizens, income basis is actually more important to them economically than either federal estate tax or GSTT. Unfortunately, many do not fully understand:

1. the concept of income tax basis and
2. the long-term consequences of abandoning the commitment to a new basis at death. The U.S. House passed an estate tax repeal bill on April 13 that eliminates the rule that assets take on a fair market value basis at death in the hands of the heirs. In its place, the bill creates a modified carry-over basis rule – the heirs receive an income tax basis equal to the decedent's basis in the assets with the estate executor having the authority to allocate additional basis (up to fair market value) of up to $1.3 million per estate and $3 million for property passing to a surviving spouse. Some groups advocating for permanent repeal have claimed that this modified carry-over basis rule sufficiently protects farm and ranch families from transfer taxes at death. That claim is unfounded. The issue is critical because the Senate is scheduled to vote on repealing the federal estate tax in September.

The key question is whether agriculture is better served with a repeal of the federal estate tax with a modified carry-over basis rule, or retaining the tax with higher exemptions and maintaining new basis at death.

The Long-Standing Rule of New Income Tax Basis at Death

Historically, gains on most assets have been eliminated at death with the notable exception of assets producing income so close to being earned that it has been viewed as inappropriate to eliminate the gain at death. That category of asset is referred to as producing "income in respect of decedent." Those assets do not receive a new basis at death now and no proposal has suggested that such assets should receive a new income tax basis in the future. Those assets include:

1. accrued interest on government bonds,
2. gains from qualified retirement plans such as individual retirement accounts,
3. gains from installment contracts entered into before death and
4. growing crops and stored crops (and livestock) produced under a share rent lease where the landowner is inactive (referred to as a "non-material participation" share rent lease).

But for other assets, gains on assets held at death by a decedent are eliminated. Technically, the "income tax basis" on such assets is adjusted at death to the fair market value of the assets (or the value used for figuring federal estate tax if different from fair market value). That adjustment is commonly referred to as a "step up" in basis inasmuch as fair market value of assets is often higher than the income tax basis of the assets before death.

Example: A tract of farmland was purchased for $50,000 in 1950. Since then, improvements of $300,000 have been made to the property and $200,000 of depreciation has been claimed. The purchase price was the initial income tax basis less the tax investment in the farmland. That figure ($50,000) is adjusted upward for improvements made ($300,000) and downward for depreciation claimed ($200,000). Therefore, the current basis for the farm is:

$$(\$50,000 + 300,000) - \$200,000 = \$150,000$$

If the farmland is sold by the owner for $500,000 in 2005, the gain would be $350,000. That's the selling

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price of $500,000 minus the current basis of $150,000. In all likelihood, part of the gain would be reported as ordinary income (because it represented depreciation previously claimed on the property) and the balance would be capital gain. The capital gain would be reported as long-term capital gain if the land had been held for more than one year (which it has in the example).

So what happens if the farmland owner dies owning the land? Under current law (through 2009), the income tax basis would be "stepped up" to $500,000, the fair market value at death. What would have been gain had the land been sold before death ($350,000) is eliminated at death. The gain is effectively wiped off the books. The land would then have a new basis in the hands of the estate (and ultimately the heirs) of $500,000. That value would then be used for purposes of figuring gain or loss on later sale or other disposition and for purposes of figuring depreciation after death.

That treatment of gain is especially advantageous to farm estates because:
1. the income tax basis of raised animals, for farmers on the cash method of accounting (and more than 90 percent of farmers are on cash accounting) is zero;
2. inventories of raised grain and feed likewise have a zero income tax basis for cash accounting taxpayers;
3. machinery and equipment are often depreciated at a faster rate than the decline in value over time; and
4. land, for many farmers, has a relatively low income tax basis because it was purchased decades ago when land values were lower.

The 2001 Tax Act Provisions

Under the 2001 Tax Act, the new income tax basis at death is scheduled to end, for deaths after December 31, 2009, with repeal of the federal estate tax. In its stead will be a one year system of "carryover basis" with the decedent's basis (or the fair market value of the property, whichever is less), carrying over to the estate and thus to the heir or heirs of the decedent. The executor of the estate, under rules scheduled to be in effect for deaths in 2010, would have authority to allocate up to $1.3 million per estate and an additional $3 million for property passing to a surviving spouse, to increase the income tax basis of eligible property but not above fair market value. Most property of a decedent, other than property producing income in respect of decedent, would be eligible for the adjustment in basis. However, some other categories of assets are also not eligible for the adjustment.

Example: A farm couple married in 1940, the husband worked as a hired man for a neighbor until World War II service was completed. After the war, the couple were tenant farmers for 10 years. In 1955, using an inheritance from the husband's aunt, the couple bought two sections of land for $125 per acre for a total purchase price of $160,000. The couple added improvements of $100,000 which were depreciated out by the time the wife died of cancer in 1992. Because the money to buy the farm came from the husband's aunt to him, the farm was considered the husband's so there was no adjustment of income tax basis at the wife's death in 1992. The husband dies in 2010 when the farmland is valued at $2,700 per acre for a total value of $3,456,000.

Result: The husband's estate would have $1,300,000 to increase the basis of estate property. If that amount is allocated entirely to the land, the income tax basis of the land would be $1,460,000 ($1,300,000 plus the basis at the time of death of $160,000). Yet the fair market value is $3,456,000. The difference is $1,996,000. Assume the two children, neither of whom is farming, sell the land for $3,456,000. The gain of $1,996,000, ($3,456,000 minus the basis of $1,460,000) assuming a combined state and federal capital gains rate of 20 percent would result in income tax liability of $399,200. Had the husband died in 2009, one year earlier, the exemption of $3.5 million would eliminate all federal estate tax liability. More importantly, the heirs would receive a step up in basis to $3,456,000 and there would be no income tax liability on sale. Therefore, the heirs would be better off by $399,200 under current law on new basis at death than under repeal of current basis rules and repeal of federal estate tax as is proposed.

This example illustrates two important points that proponent of permanent repeal overlook:
1. the provision for a $3 million basis increase for a surviving spouse is of no benefit at the death of the surviving spouse; and
2. if the $1.3 million and $3 million allowances are exceeded, carryover basis rules apply.

The Reason for Congressional Action

Because of Congressional budgetary rules, the carryover basis system, along with repeal of the federal estate tax and the generation skipping transfer tax, is scheduled to end for deaths after December 31, 2010, with the system returning to a new income tax basis at death for deaths thereafter. That result is not expected to happen and current efforts to reach an agreement in Congress over the future of the federal estate tax and generation skipping transfer tax are directed toward either repeal of the two taxes or continuation of the taxes at lower rates and with a larger exemption. The House-passed bill that the Senate will consider in September permanently repeals the federal estate tax (and GSTT), but would also make permanent the modified carryover basis rule. Thus, the discussion now occurring in Congress concerning repeal of the federal estate tax also involves the income tax basis issue.

Income tax basis is tied to the other two taxes (federal estate tax and GSTT) only because of two features of the current system:
1. the adjustment in basis occurs by reason of death and uses fair market value at death (or the value used for federal estate tax purposes if different from fair market value) and
2. repeal of the federal estate tax would result in the loss of approximately $20 billion of federal tax revenue, and a completely new basis at death would cost approximately the same amount. The impact on the Treasury is why Congress cannot repeal the federal estate tax while at the same time retaining new basis at death. The revenue loss would be too severe unless, of course, Congress increases taxes somewhere else to make up for the shortfall. That move would be politically unpopular. However, IRS data indicates that the federal estate tax can be retained with an exemption of between $3 million and $4 million along with the longstanding rule of new basis at death, and preserve almost all of the revenue presently generated by the tax.

Problems Presented by a "Modified Carry-Over" Basis Rule

Although the concept of a new income tax basis at death has been costly in terms of lost revenue, there are several important advantages of restarting the basis "clock" at the death of property owners. Proponents of complete repeal of the federal estate tax fail to tell this part of the story.

The "lock-in" effect. From an economic perspective, the most significant advantage of a new income tax basis at death is avoidance of the "lock-in" effect. Without a new income tax basis at a decedent's death, the potential income tax liability on sale of assets after death would tend to rise over time with the result that property owners would become increasingly unwilling to sell the assets and trigger the gain. The result is that market forces would become less and less effective in guiding assets into their highest and best use because of the rising income tax liability. That may seem like a minor factor for asset sales in the first few years after death. Over time, assets would be effectively locked into families. Keep in mind that the proposal to adjust basis (in 2010 under current law, and permanently as proposed in the House passed bill) is sufficient to apply to only a relatively small portion of assets of decedents, leaving other assets subject to the "lock-in" effect. Over time, the expected result would be a reduced rate of economic growth. That would not be good for agriculture.

Difficulties in obtaining necessary records. A regime of carryover basis would necessarily rely on a recordkeeping system to ascertain the original purchase price, improvements added to the property and the depreciation claimed on the depreciable assets. With a new basis at death, those records are needed only for sale or taxable exchange occurring after death. Under carryover basis, those records would be needed for all time.

Complexity in calculating basis. The type of carryover basis mandated by the 2001 legislation (and the 2005 House proposal) would assure complexity (and conflict) in the allocation of basis adjustment allowances after death. We have been down this road before - a carryover basis system was created by legislation passed in 1976, was postponed twice and finally repealed in 1980 under pressure from tax practitioners who objected to the complexity of the calculation procedure. The proposed modified carry-over basis system in the House bill will pose more problems than the 1976 version because the executor has discretion to allocate the basis increase (within the limits specified above) as the executor wishes. That will provide the possibility of greater family conflict and animosity if certain heirs are favored with a basis increase and others are not. Wills and trusts will have to be rewritten to specify the basis increase allocation in an attempt to prevent potential problems.

Untaxed Asset Value at Death

Proponents of permanent repeal often state that it is unfair to tax assets at death that have already been taxed during life. What they fail to explain is that under the existing system of new basis at death, a significant proportion of asset value at death is never subject to income tax. So, the federal estate tax is not the “double tax” that proponents of permanent repeal claim that it is. In fact, much of the value of assets held at death is unrealized appreciation in value. Poterba and Weisbrenner have found that 37 percent of all value in estates above $500,000 in value is unrealized and untaxed capital gain. Among estates valued at more than $10 million, 56 percent of value is unrealized and untaxed capital gain. As estate size grows, the proportion of value that has never been taxed (due to asset appreciation) also grows.

Conclusion

Federal estate tax is paid by estates of fewer than two percent of the decedents, and an even smaller percentage of the estates of farmers and ranchers, under current law. Yet gain on assets held at death is ultimately taxed to everyone who inherits property, up and down the income and asset scale. Therefore, the issue is more than revenue collected or not collected. A major change in the federal estate tax and the determination of gain on property after death, as has been proposed, represents a significant shift in who bears the overall federal tax burden. The House-passed bill shifts this burden to the heirs of the relatively smaller-sized estates.

Unquestionably, agriculture (and the economy as a whole) will be better served if the Congress retains the federal estate tax (albeit with a higher exemption and, perhaps, a lower top rate (which is currently 47 percent for taxable amounts exceeding $2,000,000)) along with new basis at death.