

Stepped Up Basis and Capital Gains Taxes

Key Takeaways

- Stepped up basis is a longstanding tax provision which provides that capital gains taxes are not imposed when assets are transferred at death to an heir.
- Tax law allows the heir to increase their basis in the assets to fair market value without paying capital gains tax.
- Eliminating the stepped up basis, whether by tax at death or carryover of basis, will have negative impacts on family-owned businesses, US gross domestic product (GDP), and job creation both in the immediate and long term.
- Repeal of step-up of basis would impose a tax burden on top of the existing estate tax regime, further compounding these negative impacts.
- Recent studies show repeal of Stepped Up Basis and while also increasing Capital Gains Taxes would have serious detriments to small businesses, particularly farms.

Questions

1. Does your farm have an estate plan?
2. How would your farm be impacted by elimination of stepped up basis, increase in capital gains tax rates, or decrease in the estate tax threshold?

Background

A long standing provision of U.S. tax law is that a capital gains tax is not imposed when assets are transferred at death to an heir. Furthermore, tax law allows the heir to increase their basis in the asset to fair market value without paying capital gains tax. This is referred to as a step up in basis. Step-up in basis provides that heirs only owe capital gains taxes on the amount the asset appreciates while they owned the asset and only if the asset is sold. If the asset is never sold, no capital gains taxes are collected.

Stepping up basis when an individual who is a member of a family-owned farm dies is critical to the business surviving the loss of a loved one and a business partner. **Repealing stepped-up basis by imposing capital gains taxes when assets transfer ownership at death would force many family-owned farms to liquidate assets to cover the tax burden.** This new tax would be imposed on top of any existing estate tax liability, further compounding the negative impacts and creating a second tax at death. The magnitude of the burden depends on the change in the asset value, but Farm Bureau analysis shows the tax would likely significantly exceed the annual income generated by the assets. In fact, it could take years of returns to equal the amount of the tax.

By raising the tax burden on investment, the repeal of stepped-up basis via tax at death increases the cost of capital, which discourages investment and results in less capital formation. With less capital available per worker, labor productivity falls and with it the wages of workers and, ultimately, GDP and Americans' standard of living.

A recent EY report forecasts 80,000 jobs would be lost in each of the first 10 years and GDP would decrease by \$100 billion over 10 years if stepped-up basis were repealed.

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Additionally, for every \$100 of revenue raised by repeal via taxing capital gains at death, \$32 would come out of the paychecks of workers. This report is entitled “Repealing step-up of basis on inherited assets: Macroeconomic impacts and the effects on illustrative family businesses” prepared for the Family Business Estate Tax Coalition, April 2021.

The Agricultural and Food Policy Center (AFPC) at Texas A&M University to analyze two pieces of legislation introduced in the Senate aimed to change the tax liabilities of family members when farm estates are passed from generation to generation. AFPC’s study confirms that if enacted, the two bills analyzed—the Sensible Taxation and Equity Promotion (STEP) Act, which proposes to eliminate stepped-up basis upon death of the owner and the For the 99.5 Percent Act, which would decrease the estate tax exemption—would have a devastating impact on the hardworking families who own and operate farms.

The STEP Act’s proposed changes to stepped-up basis mirror proposals discussed by the Biden administration. If it were to be implemented, 92 of AFPC’s 94 representative farms would be impacted with an average additional tax liability of more than \$720,000 per farm. **Together, the two bills would raise taxes an average of \$1.4 million on 98 percent of AFPC’s representative farms.** AFPC’s study is available online here.

AFPC maintains a database of 94 representative farms in 30 different states. This data, in conjunction with a farm-level policy simulation model, allows AFPC to analyze policy changes on farms across the country.

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Policy

Estate Taxes

Estate taxation stifles the desire to save through asset accumulation. It erodes the incentive for new entry of capital into the economy.

We applaud the governor and the General Assembly for working cooperatively to phase out the state inheritance tax.

Increased estate and gift tax exclusions have brought much needed relief to farm families. Before these changes, estate taxes were a heavy financial burden. Under the Tax Cuts and Jobs Act, which passed in December 2017, the basic exclusion amount was increased from \$5 million to \$10 million for estates of decedents dying after 2017 and before 2026. The \$10 million amount is indexed for inflation occurring after 2011. The top tax rate of taxable estates is 40%. The increased basic exclusion amount of \$10 million sunsets and therefore will not apply to estate of decedents dying and gifts made after December 31, 2025. We support the permanent repeal of the federal estate tax. Until a permanent repeal of the federal estate tax is achieved, agricultural lands should be allowed to pass to farming heirs completely exempt from estate taxes.

The federal estate-tax exemption should remain “portable between spouses.” Allowing the exemption to be transferable from one spouse to the other increases the surviving spouse’s exemption and potentially reduces the need to set up complex and costly trusts.

Stepped-up basis is particularly important as farmland is transferred from one generation to the next. We are pleased this law does not have a limitation on the stepped-up basis on inherited assets.

Capital gains tax applied on the appreciated value of inherited property has been suggested as one means of easing the federal deficit. This new tax would cause financial hardship for farm families and would hasten the breakup of viable farms into smaller, unproductive parcels.