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STEPPED UP BASIS AT DEATH—HOW HIGH?

By Randy Spiro

When the owner of an assets dies in most cases the cost or basis of the asset for income tax purposes is increased to its fair market value. When the asset is later sold, there is no capital gain on the amount of the step up. Stated differently, capital gain is only assessed on the appreciation occurring after the owner's death.

Assets such as real estate and businesses need to be appraised by an appraiser to substantiate the date of death value, but it does not follow that a higher appraisal is always better. In many estate plans, assets are divided into revocable and irrevocable trusts when one spouse dies. One purpose of this is to protect the first spouse to die's estate tax exemption (the amount the first spouse to die can give away without estate tax).

Typically, the first spouse to die's exemption is protected by placing that portion into an irrevocable trust as to which the Surviving Spouse receives lifetime use subject to duties to the children not to waste it. In 2009 the exemption is $3,500,000. If the estate consists of one piece of real estate and if appraiser A says it is worth $7,000,000 and appraiser B says it is worth $14,000,000, which appraisal is "better"? For income tax (capital gain) purposes, stepping up the basis to $14,000,000 is better than stepping up the basis to $7,000,000. But for estate tax purposes, the $7,000,000 appraisal will shield 50% of the property from estate taxes while the $14,000,000 appraisal will only shield 25%.

It is never good to shop for an unrealistically high or low appraisal, but the above illustration shows that what is good for income tax purposes may not be good for estate tax purposes. When appraising a fractional interest in real estate or a business, a discount for minority and marketability can be taken. This discount lowers the date of death value.

What if a high range appraisal and no discount were taken at the first spouse's death, to maximize the step up, on the ground that there is no estate tax until the second spouse's death? At the second spouse's death, when there is an estate tax and when a low value appraisal plus discount appraisals may be critical, the IRS may argue that the failure to take discounts at the first spouse's death precludes discounts at the second spouse's death. The IRS may also point to the first death appraisal as evidence to discredit and increase the second death appraisal.