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Capital Gains Tax Time Bomb

Many of our clients know that, upon their death, their beneficiaries will receive a “step-up” in basis, to the fair market value as of the date of death, for assets that have appreciated in value during their lifetimes. By eliminating the increase in value of appreciated assets earned during one’s life, the potential capital gains tax is significantly reduced and, often, eliminated. For example, assume that a decedent purchased a home for \$50,000 that was worth \$400,000 at death. Without the “step-up” in basis, the difference between the purchase price (the “basis”), and the sale price, or \$350,000 (\$400,000 - \$50,000), would be subject to capital gains tax. In contrast, with the “step-up” in basis, the tax is applied against the difference between the sale price (\$400,000) and fair market value (\$400,000). Calculated using the “step-up,” the gain is zero and no capital gains tax is due. This is true regardless of the value of the appreciated asset. So, for example, if Bill Gates were to pass away in 2009 and all his Microsoft stock were sold immediately after his death, his estate would pay no capital gains tax. Unfortunately, the calculation of capital gain realized upon the sale of appreciated assets is a ticking time bomb!

While there is currently an unlimited “step-up” in basis, in 2001 President Bush signed the Economic Growth and Tax Reconciliation Relief Act (EGTRRA) which repeals this “step-up” system commencing in 2010 and replaces it with a “modified carry-over” basis system. The new system is extremely complex. In general, it allows the executor to increase the basis of an estate’s assets by up to a total of \$1.3 million and up to \$3 million for assets passing to a surviving spouse. EGTRRA contains a “sunset provision” which, by its terms, effectively repeals the new law and reinstates the prior law on December 31, 2010. Thus, it is conceivable that the “modified carry-over basis” rules will only be in effect for one year.

This creates a practical problem - record-keeping. Because of the elimination of the “step-up” in basis as of the death of the owner of the asset, it is necessary for all of us to carefully maintain sufficient records from which to calculate the basis of all appreciating assets.

Moreover, under the new law, the recipient of a decedent's asset receives it at the decedent's basis *unless the executor chooses to allocate a portion of the \$1.3 million basis increase to such asset*. This gives extraordinary power to the executor. As 2010 approaches, it may be advisable for those with estates exceeding \$1.3 million to designate, in a Will or Trust, the specific assets that are to receive the step-up in basis.

Now that there is a new administration, there is an expectation that the one-year suspension of the estate tax, currently scheduled to begin in 2010, will be eliminated. However, it is still uncertain whether the change in basis calculation will likewise be rescinded. We will revisit this in the future as circumstances warrant it.