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Tax Treatment of Capital Gains at Death

When an asset is sold that has appreciated in value, such as a share of stock, the gain is taxed at rates of 0%, 15%, or 20%, with the top rate applying in 2021 when incomes exceed $501,600 for a joint return and $445,850 for a single return. These income levels are adjusted for inflation. The rates apply to an asset held for at least one year (referred to as long-term capital gains); otherwise, gains are subject to ordinary rates (the top rate is 37%). An additional 3.8% tax applies to capital gains (as well as other passive income) when incomes reach $250,000 for a joint return and $200,000 for a single return.

Capital gain subject to tax is the difference between the sales price and the basis of the asset. For most assets (such as stocks), the basis is the price paid for the asset. In the case of depreciable assets, the basis is lower than the acquisition cost due to depreciation. The part of the gain attributable to depreciation taken is taxed at ordinary rates. See CRS Report 96-769, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle for further discussion.

Currently, the capital gains tax is not levied on assets held until death. These assets are included in the estate at market value and subject to estate taxes of 35% after a significant exemption (by historical standards) of $11.7 million, as well as other exclusions. (The exemption was doubled in 2017 legislation, P.L. 115-97, and that increase will expire after 2025 unless the law is changed.) The basis for these assets is the market value at death, referred to as a step-up in basis. See CRS Report R42959, *Recent Changes in the Estate and Gift Tax Provisions*, by Jane G. Gravelle for further discussion of the estate tax.

Proposals have been made to change step-up basis, including a Biden budget proposal to tax capital gains transferred at death or by gift.

Current Law for Assets Held Until Death: Step-Up Basis

Under current rules, when an asset is transferred at death, the basis is stepped up to the market value at the time of death. If the heir sells the asset, the gain subject to tax would be the appreciation that occurred since inheriting the asset. Thus, the gain of the asset in the hands of the decedent would never be subject to income taxes. (Assets transferred by gift retain the original basis of the donor.)

Because of this step-up rule, one justification for the estate tax has been as a backstop to the escape from the capital gains tax, although the estate tax is now subject to a historically large exclusion and less effective in performing a backstop rule than in the past. In 2019, 6,409 estates were subject to the estate tax—a decline of nearly 60% since 2010.

Potential Revisions in the Tax Treatment of Capital Gains at Death

Two proposals have been made for changing the tax treatment of capital gains at death: adopting carryover basis and taxing capital gains at death.

Carryover Basis

Under carryover basis, an asset inherited at death would retain the basis in the hands of the decedent. In this case, the gain would not escape taxation but would be subject to tax when and if the heir sold the asset.

Carryover basis has been proposed as far back as 1942 and in two instances has been enacted into law. The first instance was in 1976, although the law was retroactively repealed in 1980 and never took effect. The second instance was in 2010. In the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the estate tax was scheduled to be reduced and eliminated entirely in 2010 to be replaced by carryover basis. Although the estate tax was restored, executors in that year could elect to pay the estate tax or choose carryover basis, with a $1.3 million exemption. Estimates from researchers at the Department of the Treasury indicated that 60% of estates opted for the carryover basis.

In December 2019, Senators Romney and Bennet proposed carryover basis with an exemption of $1.6 million for singles and $3.7 million for married couples, although this plan was never introduced as legislation.

The revenue gain from a carryover basis regime would rise over time as heirs sell assets. In its 2020 Budget Options report, the Congressional Budget Office estimated that adopting carryover basis beginning in 2021 would raise revenue by $110 billion from FY2021 to FY2030, rising from $1.2 billion in FY2021 and $4.8 billion in FY2022 (the first full year) to $18.4 billion in FY2030.

Taxation of Capital Gains at Death

Another alternative for the treatment of capital gains at death is to treat death as a realization event (that is, treated as if the decedent had sold the asset in the last year of life) and tax capital gains at that time. The heirs would increase the basis by the gains (i.e., their basis would be market value at time of death, the same as under present law). The estate value would be reduced by the capital gains tax paid.

Proposals to tax capital gains at death date back to President Kennedy in 1963 and were proposed by the Ford and the Obama Administrations.

Canada has taxed capital gains at death since 1971 but has no national estate tax, while Australia, Ireland, and the United Kingdom tax capital gains transferred by gift.

H.R. 2286 (Pascrell) and a proposal by Senators Van Hollen, Booker, Sanders, Warren, and Whitehouse (not yet introduced as legislation) would tax capital gains at death, with an exemption for the first $1 million of gain. Several bills in the 116th Congress—H.R. 8352 (Bass), H.R. 3922 (Pressley) and S. 2231 (Booker)—would have taxed capital gains at death. These bills had a smaller exemption of $100,000, with a $1,000,000 exemption for farm property (to be recovered if the farm property were sold within 10 years).

The Biden budget proposal would raise the capital gains (and dividend) tax rate to the top ordinary rate for taxpayers with incomes over $1 million for married couples and $500,000 for singles. The current top rate is 37%, raised to 39.6% after 2025 under current law, but there is also a budget proposal to raise the rate to 39.6%. The 3.8% tax on net investment income would continue to apply. The budget plan would also tax capital gains at death or by gift with a $2 million exemption for married couples and a $1 million exemption for singles. Gains on assets given to spouses and charities would not be taxed. Gain on family businesses would not be taxed as long as the business remains with the heirs, and gains on non-liquid assets could be paid over a 15-year period. The combined higher rates and taxation at death or by gift is projected to yield $332 billion over FY2022-FY2031.

According to the Joint Committee on Taxation, the exclusion of capital gains at death costs $40 billion per year, although this amount would be substantially reduced with a large exemption. A study in 2013 found that an exemption of $1.3 million (indexed) would reduce the yield by 45%.

Issues in the Tax Treatment of Capital Gains at Death

Arguments for Revision

Failure to tax capital gains unless realized allows high income taxpayers to significantly reduce, especially at high income levels, their effective tax rates. These taxpayers have a major portion of their income from capital income, and a significant share is estimated to be from unrealized capital gains. The step-up basis is viewed as a main contributor to that effect.

As noted earlier, the estate tax often has been viewed as a backstop for the failure to tax unrealized capital gains and other types of income that escape income taxes, with the large current exemptions making it less effective for this purpose.

A related argument for adopting carryover basis or taxing gains at death is that the current treatment is viewed as a major reason for the lock-in effect; that is, the tendency to hold on to assets to avoid the capital gains tax. This effect not only leads to distortions in portfolio choice and liquidity but also limits the potential for increasing revenue yield by raising capital gains tax rates on realized gains, which are a large part of the income of high-income individuals. While there is disagreement about the magnitude of behavioral responses (see CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle), a significant offset from the revenue gained on a static basis is likely when capital gains tax rates are raised, particularly if they were to be raised to ordinary rates.

For addressing these objectives, taxation at death is a more effective approach, and the option of carryover basis would allow wealthy family dynasties to avoid capital gains taxation indefinitely.

Arguments against Revision

For both approaches, a traditional argument, especially important in retroactively repealing the carryover basis enacted in 1976, has been the concern about measuring basis. Generally, the executor of the will, who is responsible for paying the tax, did not actually hold the assets. Although taxpayers are responsible for keeping track of basis, they may not have done so if they expected the heirs to benefit from stepped-up basis. One option for this issue is to allow a safe harbor basis of a certain percent of the asset's market value.

A second criticism, which applies to the option of taxing capital gains at death, is liquidity and the potential for forced sales of assets, such as family businesses. This issue already exists under the estate tax and is partially addressed by allowing payment of the tax in installments. One proposal by Harry Gutman, former chief of staff of the Joint Committee on Taxation, would apply the tax only to marketable securities, with family businesses subject to carryover basis, taxation at the rate applicable to the decedent, and with an interest charge for the deferral of tax.

A third criticism is the additional complexity of taxing capital gains at death. This concern could be addressed by providing an exemption adequate to confine the tax to wealthy individuals with resources to deal with tax complexity.

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