Opinion: This is the tax break America’s 1% will cling to — even after death

By Robert Pozen
Published: Dec 11, 2019 4:12 p.m. ET

Step-up basis at death is the key to tax reform

If Congress truly wants to address the concerns about taxing the wealthy, it needs to start by repealing the current rules that automatically step up the tax basis of capital assets at death. By collecting capital gains taxes on appreciated assets at death, Congress can generate significant tax revenues by increasing the top rate on realized capital gains, while preventing wealthy families from passing down appreciated assets from generation to generation without ever paying capital gains taxes on these assets.

As things stand, the highest-income-earning Americans — the .001% whose incomes top $50 million a year — derive most of this income from investments, rather than salaries or other forms of ordinary income. Yet the maximum tax on capital gains and dividends is now 23.8%, much lower than the maximum rate of slightly more than 40% on wages and interest income.

Almost all the Democratic candidates for president propose to increase the tax rate on capital gains to equal the rate on ordinary income. Yet, if Congress did raise the rate on capital gains above 29% without enacting other tax reforms, federal tax revenues would actually fall, according to the Tax Policy Center. Why? Because that tax is triggered only when an asset-owner realizes capital gains — which is a discretionary decision. If the rate on capital gains rises sharply, America’s wealthy will substantially slow the pace at which they sell their securities, real estate, and other capital assets.

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Under the current tax rules for the step-up in basis at death, much of the unrealized capital gains held by American householders will never be taxed as income. Suppose when I was young, I bought land for $1 million, which was worth $5 million at the time of my death. I bequeathed that land to my daughter, who sold the land on the day of my death. She
would not recognize any capital gain because the tax basis of the land would automatically be stepped up to $5 million from $1 million upon my death.

Accordingly, the current rule for stepping up the tax basis of appreciated assets at death creates two major problems.

First, it materially reduces federal tax revenues, since a significant portion of unrealized capital gains escapes income tax. If the capital gains in appreciated assets were taxed at death, that change would generate **in excess of $400 billion over the next decade**, according to the U.S. Treasury.

Repeal of this rule would also allow Congress to generate additional revenue by raising the tax rate on realized capital gains to equal the rate on ordinary income. If appreciated assets were subject to capital gains taxes at death, then wealthy families would be much more likely to sell such assets during their lives. Accordingly, the revenue-maximizing rate for capital gains would then increase to more than 40%, according to a **budget model from The Wharton School**.

Second, the current step-up rule at death allows wealthy families to bequeath assets over multiple generations without ever paying capital gains tax. To continue the example above, suppose my daughter held the inherited land, which appreciated to $11 million, and bequeathed it to her son. If her son sold that land on the date of her death, he would not recognize any capital gains on that sale. The tax basis of the land would be automatically be stepped up to $11 million from $5 million upon her death.

Repeal of the step-up rule at death would be responsive to the existing political concerns about income equality.

Thus, repeal of the step-up rule at death would be responsive to the existing political concerns about income equality. In 2018, U.S. households held almost **$100 trillion in household wealth**, according to the Brookings Institution. But that wealth is distributed unevenly among income groups. The top 1% of American households by income held 29% of total household wealth, and the top 20% held 77% of total household wealth.

One argument against repeal is the liquidity concerns for assets that would be subject to the capital gains taxes at death. These concerns could be met by creating exclusions for personal jewelry, household furnishings, and primary residences. In addition, payment of capital gains taxes for the appreciation of family farms and small family-owned businesses **could be delayed until the farm or business ceased to be family owned**, and spread out over 10- or 15 years.

Another argument against repeal of step-up in basis at death is that wealthy householders would need to value assets that may not have a readily available market price, like stocks and bonds do. This argument is weak because all the assets of most wealthy people must already be valued at death to determine if they are subject to estate tax. To coordinate the application of these taxes, Congress could repeal step-up in basis only for those dying with a certain asset levels, for example $5 million.

As its top priority, Congress should abolish the current rule automatically increasing the tax basis of all appreciated assets at death. This statutory amendment would raise tax revenues directly on the assets bequeathed at death by wealthy families, and indirectly by allowing the capital gains rate to be raised to 37% or 39.6% without losing federal tax revenues. This amendment would also constitute a significant step toward addressing inequality concerns by preventing wealthy taxpayers from escaping capital gains taxes permanently by passing appreciated assets from generation to generation.

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