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Anticipating Joe Biden's proposed capital gains tax

The New York Times reported that former Vice President Joe Biden's tax proposals include one under which "People would have to pay income taxes on unrealized gains at death. That would change current law, which exempts those gains and imposes taxes only on the difference between the value at death and the value when later sold by heirs."



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An important aspect of tax planning for real estate investors (including children who expect to inherit their parents' home), those invested in the stock market, and owners of closely held businesses is the so-called "step-up in basis at death." IRC Section 1014. The Internal Revenue Code provides that "the basis of property in the hands of a person acquiring the property from a decedent ... shall ... be (1) the fair market value of the property at the date of the decedent's death."

Example #1: Mom owns a home with a \$1,000,000 basis. At her death the home is worth \$3,000,000. Son immediately sells it for \$3,000,000. Son's basis becomes the date of death \$3,000,000 fair market value. As a result, Son pays no capital gains tax on \$2,000,000 gain.

The New York Times reported, on March 6, 2020, that former Vice President Joe Biden's tax proposals include one under which "People would have to pay income taxes on unrealized gains at death. That would change current law, which exempts those gains and imposes taxes only on the difference between the value at death and the value when later sold by heirs."

Example #2: Mom owns a home with a \$1,000,000 basis. At her death the home is worth \$3,000,000. Son immediately sells it for \$3,000,000. In California, under current law, Son would owe a tax of as much as $(20\% + 13.3\% + 3.8\% =)$ 37.1% on the \$2,000,000 gain.

In fact, under Biden's plan "Capital gains would be taxed at the same rates as ordinary income for taxpayers with incomes above \$1,000,000."

Example #3: Mom owns a home with a \$1,000,000 basis. At her death the home is worth \$3,000,000. Son immediately sells it for \$3,000,000. In California, under current law, Son would owe a tax of as much as $(37\% + 13.3\% =)$ 50.3% on the \$2,000,000 gain.

It gets worse. "Mr. Biden would raise the top individual tax rate to 39.6% from 37%...."

Example #4: Mom owns a home with a \$1,000,000 basis. At her death the home is worth \$3,000,000. Son immediately sells it for \$3,000,000. In California, under Biden's proposal, Son would owe a tax of as much as $(39.6\% + 13.3\% =)$ 52.9% on the \$2,000,000 gain.

What advice will tax advisors give should this horror show come to pass?

First, Son can set up a complex (meaning it pays its own taxes) trust for his children's benefit. He would rent the home for two years (to a stranger). He would sell it to the children's trust for \$3,000,000, 10% down and a 90% note. (Son may have to make at least a \$300,000 gift to the children's trust so it has enough to make the down payment.) At the end of two years and one day, the children's trust would sell it for its then fair market value. Assume that, at that time, the home is worth \$4,000,000. The children's trust would have a basis of \$3,000,000 and would pay a tax only on the \$1,000,000 it receives in excess of its basis. IRC Section 453(e).

Is there a limit on the use of this technique? Yes. The Internal Revenue Code limits to \$5,000,000 the amount one individual can create in installment notes in any one year. If the individual creates more than \$5,000,000 of installment notes in any one year, the excess is subject to a penalty: the taxpayer must pay a non-deductible interest at the IRS underpayment rate on the gain inherent in the excess note. Given that the penalty is nondeductible, no taxpayer would be enthusiastic about paying it. Also, if that excess note is outstanding even for one day in the calendar year, it is owed as if it were outstanding for the entire year.

Example #5. Son sets up a complex trust for his children's benefit. He rents the home for two years to a stranger and immediately, on Dec. 31, sells it to the children's trust for \$6,000,000. For the \$1,000,000 in excess of son's \$5,000,000 limit, we look at the tax inherent in the \$1,000,000. Assume, under Biden's plan, the tax is 52.9%. At the current IRS underpayment rate of 5%, son would owe \$26,450 for each year (including the year in which he sells it to the children's trust on Dec. 31) the note is outstanding. If son is in the maximum bracket, he would have to earn \$56,157 to pay the \$26,450 penalty.

Second, son can rent the property to a stranger. Once it has been rented for at least one year, assuming the house is not subject to debt, son can contribute it to a charitable remainder trust (CRT) of which son can be the trustee. Son, as trustee, can then sell the house for its then fair market value. Assume that, at that time, the house is worth \$4,000,000. The CRT does not pay taxes on the sale. IRC Section 664. Son can receive a distribution for the rest of his life from the CRT. Assume son is 65 years old. That distribution could be as little as 5% of the trust's assets' value or as much as 19.36% of the trust's assets, as valued each year. Also, son would get a charitable contribution deduction of as much as \$1,800,000 (if he takes out 5%) to as little as \$400,000 (if he takes out 19.36%).

Third, son can rent the property to a stranger. Once it has been rented for at least one year (two is better), he can enter into a tax-free exchange under IRC Section 1031. In that exchange he can acquire an apartment building for \$4,000,000. Of course, son would not be restricted to an apartment building. He might buy an office building, warehouse or even -- if he is not afraid of Amazon -- a shopping center.

In conclusion, this aspect of former Vice President Biden's tax proposals will be a significant change for high bracket taxpayers who will inherit appreciated assets from their parents. However, all hope will not be lost. Sophisticated planning will be available to mitigate the impact. □