

AVOID COST-BASIS CONFUSION IN YOUR ESTATE PLAN

By Kevin Lanigan, Carlson Estate Planning

One of the lesser-known provisions in estate law that took place this year (along with the temporary repeal of the estate tax) could result in filing headaches along with increasing tax burdens for heirs.

That comes from a change in the rules governing the cost basis of inherited assets. Basically, the cost basis is the starting point that is used to determine the size of an investment's capital gain or loss. It is typically the price paid when a security or other asset is purchased. For example, if you buy a stock for \$10 and sell it for \$15, your cost basis is \$10; your capital gain is \$5.

Through 2009, heirs received a tax break when such appreciation came from inherited assets. In general, they received a "step up" in basis of bequeathed assets to the assets' fair market value on the day that the original owner died. Then, whenever they sold the asset, they'd owe capital gains tax on the difference between the sale price and their stepped-up cost basis- not the original purchase amount. Keep in mind that if on the date of death the fair market value was less than the original cost of the asset, the value will be "stepped down."

Beginning in 2010, however, the step-up provision has been capped at \$1.3 million worth of appreciation; surviving spouses can step up an additional \$3 million. After that, the cost basis is calculated from the price of the asset when it was first purchased. For many inherited assets, the original purchase date may have been many decades before creating a potentially much larger capital gains bill when the asset is sold.

The real losers here may be people with medium sized estates which include assets such as businesses, real estate or stockholdings which have appreciated in value over the years. While they might not necessarily have paid estate taxes under the previous rules because of the size of their estates, now they are likely to be assessed a capital gains tax.

Running the numbers

Indeed, one congressional study estimates that more than 70,000 estates will experience additional tax-filing and compliance issues because of this situation- and many of those estates also have larger tax bills than they would otherwise have had. (12/27/2009 New York Times Article)

What you can do

Whether these provisions will remain in effect is anyone's guess. Some commentators have said that the further you get into the year, the less likely it is that Congress will change the rules for 2010. But in reality, no one knows for sure what might happen.

In light of the uncertainty it is important to consult your advisors to ensure that the language in your estate plan documents is flexible. The current situation also provides an important reminder: Know your basis at all times. If you don't, now is the time to gather and organize your records- both for your own benefit and for that of your heirs.