

Tax Reform: The Federal Estate Tax

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Tax reform is a promise that the current administration keeps pushing. Despite the delays in addressing other political issues, the administration has not backed down from its announced plan to overhaul the tax code. A big part of that overhaul involves the repeal of the federal estate tax.

Currently, about \$5,500,000 of a decedent's estate is exempt from the federal estate tax. Every dollar exceeding that exemption amount (subject to other deductions) is subject to a tax at the rate 40%. The White House promises a full repeal of this estate tax. Interestingly, eliminating federal estate tax is favored by the vast majority of Americans, even though as it stands it impacts fewer than the top 100th of the top 1%.

Senate Bill 726, introduced by California State Senator Scott Wiener in late February, would replace a repealed federal estate tax with a California estate tax. In effect, if the federal estate tax is repealed, the California law would spring to life and levy a California estate tax equal to what would have been levied by the IRS. As envisioned under this bill, if the federal estate tax is repealed, California residents would simply replace "US Department of Treasury" with "California" as the payee on a check to pay estate taxes.

The wealthy and aging California population hanging on for an estate tax repeal shouldn't hold their breath. In fact, a federal estate tax repeal could result in dramatically higher taxes. Many believe if the federal estate tax gets repealed, it will be replaced by removing the "basis step-up on death." Current law provides that basis in assets held at death are stepped up to fair market value. For example, if an individual's only asset is a home worth \$1,000,000, the basis in that home will be stepped up to \$1,000,000 at that individual's death regardless of what it was before. The heirs could sell that home the next day and not owe any capital gains tax. If the federal estate tax is repealed, many believe that basis will no longer get a step-up on death and heirs will simply inherit the basis the decedent had prior to death. Therefore, assets later sold would be subject to capital gains tax.

Senate Bill 726 coupled with potential new federal tax basis rules could dramatically raise taxes on California residents. Residents could end up paying both the estate tax and a capital gains tax upon sale. A wealth exodus from California would not be out of the question. Proactive planning now, however, may keep you from holding the proverbial bag.