Stepping Back By Not Stepping Up

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One of the most concerning of the tax proposals being floated in Congress this year, among many, is the proposed elimination of the step-up in basis upon death and requiring the payment of capital gains taxes upon death. The NARO Executive Committee recently voted unanimously to oppose elimination of the step-up in basis, especially if it triggered the automatic payment of capital gains on property that had not been sold.

First, a brief primer on estate taxes. When you die, your estate gets valued, and your financial advisor will decide whether your heirs need to file an estate tax return. If your estate is worth more than $11.5 million, after exemptions and credits, you must pay estate taxes on the net taxable estate in excess of $11.5 million. The tax rate at this level is 40%. If your estate does not have the cash to pay the taxes, your heirs must sell assets or borrow money to pay them. Among the current tax proposals, one is to reduce this cap from $11.5 million back to $3 million, which it has not been seen since 2008.

Another thing happens when you die, which is your heirs receive your assets with a free "step-up" in basis. This means that if you decide to file an estate tax return, even though your estate is worth less than $11.5 million, and put values on the estate return, your heirs inherit that property with the higher basis on the date of death. This means that if the heirs ever sell the property, the capital gains they pay is the difference between what they sell it for and the stepped-up basis at your death, not the basis that you bought the property for or inherited it at. This step-up can result in a substantial capital gains savings and encourages people to file estate tax returns so they can take advantage of the free step-up in basis. It also encourages taxpayers to put a fair value on estate tax returns because of the tradeoff. If you put too conservative a value on the estate tax return to stay below the $11.5 million cap, you are also lowering the basis that your heirs will have to use to calculate capital gains if the property ever sells. In other words, the system has some checks and balances.

Next a brief history lesson. In the 1950s and 1960s, when the estate cap was around $60,000, many family farms, and ranches, particularly those that owned minerals, got caught and had to pay substantial estate taxes due to lack of estate planning. Considered "land rich but cash poor", the heirs had to sell land to pay the estate taxes. In fact, it was such a common thing that it is not unusual to see in chains of title from this era proof that estate taxes had been paid to make sure someone was not buying land or minerals that owed estate taxes.

The startling proposal out of the Biden administration is to eliminate the step-up in basis and require heirs to go ahead and pay the capital gains owed at the time of your death, **even if the property has not sold**. This would be a disastrous outcome for people that hold family ranches, farms, and family mineral holdings.

So, in other words, if you are passing down minerals you inherited, which means that the cost basis is probably very low, then your heirs will owe up to 20% of the value on the date of your death as a long term capital gain. That amount rises to 23.8% with net investment taxes under current law and will rise to 39.6% if you are making over $1 million per year and if other parts of these tax proposals pass.

As a rough rule of thumb, the IRS may challenge any valuation of producing minerals that is less than three times your annual royalty revenue. If you have land that is currently under lease, but not yet

producing, then anything less than the bonus paid is subject to being challenged. These are very rough rules of thumb only.

Further, the automatic triggering of a capital gains tax would put many families in the unenviable position of trying to find out what their basis was. For inherited minerals, or for minerals or land that was purchased decades ago, this can be almost impossible unless you have excellent recordkeeping.

Further, it completely obliterates the incentive to put a fair value on an estate tax return to take advantage of the automatic step-up in basis. If passed, all of the incentive will be to put values as low as possible to minimize the capital gains tax.

Already, groups are clamoring about the impact on family ranches and farms. However, even if credits or exemptions get put into the final bill for these groups, expect much less sympathy for family mineral holdings and increased documentation and recordkeeping.

Further, there is, yet no proposal to limit this proposal only to people that are making more than $400,000 a year, which is President Biden's stated threshold in which he has promised not to raise taxes.

And what is the general justification for these tax proposals, other than raising additional revenue? The frequently cited reason is income inequality. But who benefits if your heirs are required to sell part of your mineral holdings to pay estate taxes? Are your less fortunate neighbors and friends going to be the buyers of these minerals? No. It will be the hedge funds and other large mineral buying companies that have raised billions of dollars to buy minerals across this country. In other words, this proposal, ostensibly to fight income equality, will actually concentrate mineral holdings in the hands of those who have more means than you do.

The proposal would also have arbitrary and disproportionate impacts. If you own minerals on a limited number of acres but have the good fortune of recently having had one of the new, large horizontal wells drilled on it, the current income may be a true blessing. However, as we know, it can also decline quickly, especially with the decline curves on shale wells. So, a person who has recently had wells drilled on them, and then dies before the decline curve sets in, the heirs will have to hire valuation experts to show the true value was much lower than the recent income indicates. You may be faced with a large capital gains bill, to be paid with rapidly declining royalty checks.

The other side effect of this proposal would be a guaranteed full employment act for all estate planning lawyers. Any radical shift in tax policy like this will cause a huge surge in redone estate plans, gifting, and other mechanisms for trying to minimize expected estate taxes.

Finally, and most discouraging, is the extreme double taxation aspect of it all. These properties were purchased by someone in your family with after-tax money that they already paid income tax on. You paid income taxes on the royalty that was generated also. Keep in mind your minerals are not "income producing" assets. They are assets being depleted by oil production, and therefore declining in value while the production is going on. Now, if you die, your heirs get the pleasure of forking over another 20% to 39.6% of your minerals' values in taxes to the U.S. government even if they have not sold and generated the cash to pay the tax bill. Somewhere along the way I suspect that that adds up to more than 100%.

Eliminating the step-up in basis? It is a major step backwards.