Capital Gains Tax Advantages for Married Couples and California State Domestic Partners

The "Double Step-Up" and How to Take Advantage of It

By Alma Soongi Beck, Esq.

DISCLAIMER: This article contains general information about issues and should not be construed as legal advice. Every case must be analyzed independently, based on the specific facts of the case. If you have questions or concerns about your particular situation, please consult an attorney.

The surviving spouse of a marriage receives a "double step-up" in basis for purposes of the federal and state capital gains tax, on jointly held capital assets – such as a house, land, stocks, or securities – when that asset is later sold. The double step-up can save tens or hundreds of thousands of dollars – sometimes millions – in capital gains tax. Registered California domestic partners (hereinafter CA DP's) cannot take advantage of the federal double step-up, under current federal tax law. However, under AB127, the "State Income Tax Equity Act" which was passed by the California legislature in 2007, the surviving member of a registered domestic partnership now receives a "double step-up in basis" for purposes of the state capital gains tax, provided they held title to the property as community property prior to the first partner's death.

Capital Gains Basis – a Summary

When one buys property, like a home, stock accounts or other capital assets, the purchase price is generally known as the "basis" (or "capital gains basis") for that property. Added to the basis is any amount spent on improvements. Later, when the owner sells the property for more than its basis, she pays federal and state capital gains tax upon the difference. If the owner had lived in the property as a primary residence (as defined in the Internal Revenue Code) for two out of the previous five years, the owner is entitled to an exemption from capital gains tax of the first $250,000. If there are two owners, each one is entitled to the full exemption with regard to his share of the property, and as long as they meet the parameters of the exemption rule.

Essentially, after one spouse or CA DP has passed away, the step-up in basis rules can save a surviving spouse or CA DP tens or hundreds of thousands of dollars – sometimes millions – in capital gains tax upon the sale of a capital asset. The higher the capital gains basis, the lower the taxes will be upon sale of the capital asset.

"Basis Step-up" upon Inheritance of Capital Assets

The concept of the capital gains "basis step-up" at death is probably best explained by way of example.

Let's say Abby, a California resident, has a house that she buys at $100,000, and spends $50,000 in improvements. Her capital gains basis is now $150,000. Many years later, the property then appreciates to $900,000. If Abby then sells the property, her capital gain is $750,000, minus the costs related to sale. If she lived in the property for two out of the last five years as her primary residence, she is entitled to a $250,000 personal residence exemption, bringing her capital gain down to $500,000. With a federal capital gains tax rate of 15% (in 2009), Abby's federal capital gains tax owed upon sale would be approximately $75,000. With a state capital gains rate of 9.3% (in 2009), her state capital gains tax for the sale would be approximately $46,500. The total capital gains tax would then be approximately $121,500.

What if, instead of selling the property, Abby gives the property to her daughter, and then the daughter sells it? Abby's daughter essentially takes the property with its original $150,000 basis; this concept is called "carry-over basis". That means that if the daughter then sells the property, her gain is approximately $750,000 as well. If the daughter has not lived in the property as a primary residence in two out of the last five years, the $250,000 personal residence exemption would not apply, resulting in a federal capital gains tax of $112,500 (calculated at 15%) and a state capital gains tax of $69,750 (calculated at 9.3%), for a total capital gains tax bill of $182,250

Here's the catch. If Abby holds the property until she passes away, and then her daughter **inherits** the property from her, the capital gains basis automatically "steps up" to the property's value as of Abby's date of death. So if the property is worth $900,000 on Abby's date of death, her daughter now inherits the property with a $900,000 capital gains basis. If the daughter then sells the property for $900,000, there is now no capital gain, and no capital gain tax. **Simply by inheriting the property at Abby's death, versus having the property given to her while Abby was still alive, Abby's daughter has saved $182,250 in capital gains tax.** Internal Revenue Code Section 1014 and 1015; California Revenue and Taxation Code Sections 18044 and 18045.

The application of this rule to a property that is co-owned is slightly more complicated. Let's say Beth and David – an opposite-sex couple who are not married and not CA DPs – buy property together as equal owners for $100,000, and spend in equal shares $50,000 in improvements. Beth's basis is now $75,000, and David's is $75,000, resulting in a total $150,000 of capital gains basis between the two of them. Then many years later, when the property is worth $900,000, David passes away. In this example, because David only owned one-half of the property, the "basis step-up" concept would only apply to David's one-half interest in the property. The basis on David's half is then stepped up to $450,000, and Beth's stays at $75,000, resulting in a total basis of $525,000. If Beth then sells the property, her capital gain is $375,000. If Beth lived in the property two out of the last five years, she is then entitled to a $250,000 personal residence exemption, bringing her capital gain down to $125,000, and a resulting capital gains tax of $18,750 on the federal level, and $11,625 on the state level, for a total capital gains tax bill of $30,375.

Changing the facts slightly can reveal a huge advantage on capital gains taxes. Let's say, instead, that Beth and David are **married** and that they own the property as **community property**. Now when David dies, Beth gets not only a basis step-up on the share owned by David, **but she also gets a basis step-up on her own share, even though it was not inherited from David**. This is called the "double step-up in basis." In real numbers, it means that after David dies, the tax basis on the whole property is $900,000, and if Beth can then sell the property for $900,000, there is no gain and no tax on the sale.

Let's now change the facts again. Let's say, instead, that Beth is in a same-sex relationship with Carol and that they are registered in California as CA DPs. Moreover, the year is 2006, one year before AB127 took effect. If Carol passed away in 2006 when the property was worth $900,000, Beth is stuck with a step-up in basis only on Carol's one-half and ends up with the same $30,375 capital gains tax burden discussed in the earlier example.

If instead, we suppose, now, that Carol passes away in 2007 or later, after AB127 has taken effect. **Beth would instead get a "double step-up in basis" for the state income tax portion of the capital gains tax, saving her $11,625 in state capital gains tax if she sells the property for $900,000**. NOTE: This rule will also apply if Beth and Carol are among the 18,000 same-sex couples who got married in 2008 and whose marriages are still valid; the rule is a community property rule, which applies to both CA DPs and married couples, including both opposite-sex and same-sex couples.

CAVEAT: AB127 is a **California state** tax rule, and as such, it does not change federal tax law. In February 2006, a year after AB205 took effect, which is the law that granted CA DPs the same rights and responsibilities as married couples under most California state laws, the Internal Revenue Service (IRS) Chief Counsel issued an opinion stating that even though community property is an integral part of a California domestic partnership under California law, the IRS would not recognize the community property of California domestic partners for federal tax purposes.[1] As a result, in the above example, even though Beth would owe no state capital gains tax, she still only gets a single "basis step-up" for her federal capital gains taxes, requiring her to pay, still, approximately $18,750 in federal capital gains taxes.

So What Should Couples Do to Ensure they Receive a Double-Step Up in Basis?

First and foremost, couples should discuss this issue with an estate planning attorney, ideally someone who is familiar with California property laws and who keeps up on the constantly changing tax laws. Seeking counsel of an experienced attorney can help avoid pitfalls.

The discussion could include, but is not necessarily limited to:

1. Whether to get married or register as CA DPs;
2. Whether the couple's existing capital assets are already community property in character;
3. Whether the couple should change how they hold title to certain assets;
4. If capital assets (such as the house) have been transferred into revocable living trust(s), whether the property should be taken out of the trust(s) and then transferred back in, in order to clarify the community property nature of the property; and/or
5. Whether to execute a transmutation agreement, which is an agreement that changes the character of property from community to separate or vice versa.

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For same-sex couples, the risks are even greater. Opposite sex couples have an "unlimited marital deduction" for transfers between spouses, under federal tax law. IRC Section 2056 et al. However, same sex couples who are married or CA DPs are still not recognized for federal tax purposes. As a result, a transfer of property between same-sex partners or a transmutation from community to separate property, or vice versa, can trigger a taxable gift between partners under federal gift tax rules. Such actions could require the filing of a federal gift tax return, the payment of federal gift taxes, or could increase the potential tax liability at the death of one partner under federal estate tax rules. The tax consequences can be very costly, as federal gift tax rates are 35-45% under current tax law.

If you have any questions whatsoever about the issues raised in this article, please seek legal counsel. An attorney may not require much time to figure out the application of these rules to your situation and to implement a simple solution.

A few hundred dollars spent now can save the thousands of dollars (and in some cases, tens of thousands) that could be required later to fix mistakes, if the mistakes are even fixable.

Be safe.

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1 Office of Chief Counsel, Internal Revenue Service, Memorandum No. 200608038 (February 24, 2006). The question of whether the 2006 IRS Chief Counsel Opinion will withstand a federal challenge is still much debated, due in large part to its apparent conflict with U.S. Supreme Court precedent under Poe v. Seaborn, 282 U.S. 101 (1930) and its progeny. Poe established the principle that the IRS is required to recognize community property, because community property is a state property right, at least back at the time when community property only applied to opposite sex married couples. The analysis and implications of the 2006 IRS Chief Counsel Opinion in light of the U.S. Supreme Court cases is complex, and beyond the scope of this article.

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