Money Matters

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Skloff Financial Group Question of the Month

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Q: We read 'How a Gift Can Be a Tax Dream or a Tax Nightmare' Part 1 and Part 2. We also read 'How To (Legally) Avoid Taxes When Selling Your Home' Part 1, Part 2 and Part 3. Furthermore, we read 'How Gifting Versus Selling Your Home Can Be a Tax Dream or a Tax Nightmare' Part 1, Part 2 and Part 3. Then, we read 'How a Step-Up in Basis Can Be a Tax Dream' Part 1, Part 2 and Part 3. Lastly, we read 'How Community Property States Versus Separate Property States Can Be a Tax Dream or a Tax Nightmare' Part 1. Can you provide strategies that optimize taxes in community property states and separate property states?

The Problem – Understanding the Key Differences Between Community Property and Separate Property States Can Be Confusing
What's mine is yours and what's yours is mine, in marriage, right? Like many financial questions, the answer depends on the circumstances.

The Solution – Understanding the Key Differences Between Community Property and Separate Property States
Whether it is estate planning, marital planning or tax planning, understanding the key differences between community property and separate property is critically important to develop the best plan. Let's examine tax planning strategies below.

According to the Internal Revenue Code Section 1014, the cost basis to a beneficiary of property from a decedent is the fair market value of the property at the date of the decedent's death. When the value of the property (assets) has appreciated over the decedent's lifetime, the beneficiary receives a "step-up in basis". When the value of the property (assets) has depreciated over the decedent's lifetime, the beneficiary receives a "step-down in basis".

Community Property States. In community property states, the surviving spouse receives a **full step-up in basis** on both ownership portions of all jointly owned assets. Let's look at an example of a younger, healthy spouse and an older, terminally ill spouse with a two-year life expectancy. To celebrate their marriage 30 years ago, they purchased $100,000 of a stock that is now worth $1,000,000. Unfortunately, just over a year later, the terminally ill spouse dies. If the stock's value remains at $1,000,000, the surviving spouse receives a full step-up in basis to $1,000,0000. The surviving spouse can immediately sell the stock for $1,000,000 and pay no taxes – **a tax dream**. See the table below. Prior to their marriage, the terminally ill spouse purchased $100,000 of a stock that is now worth $25,000. If the terminally ill spouse dies when the stock is still worth $25,000, the surviving spouse receives a step-down in basis to $25,000 – **a tax nightmare**.
Instead: Prior to their marriage, the terminally ill spouse purchased $100,000 of a stock that is now worth $25,000 and purchased $50,000 of a stock that is now worth $125,000. Rather than wait for the terminally ill spouse to die to receive a step-up in basis, the terminally ill spouse can sell their two stocks. The first stock's loss would wipe out the taxes on the second stock's gain - **a tax dream**. Then, the proceeds can be invested immediately as community property.

Separate Property States. In separate property states, the surviving spouse only receives a **50% step-up in basis** of all jointly owned assets. Looking at the same circumstances as above, but in a separate property state, changes the outcome. The surviving spouse adds their 50% of the cost to the 50% of the date of death value to determine their basis after the step-up in basis. The calculation is as follows: ($100,000 X 50%) + ($1,000,000 X 50%) = $550,000. The surviving spouse can immediately sell the stock for $1,000,000 and will be left with $892,900 net of taxes. The calculation is as follows: ($1,000,000 - $550,000) – ($450,000 X 20%) – ($450,000 X 3.8%) = $892,900 – **a tax nightmare**. In this example, the surviving spouse was subject to a 20% capital gain rate and a 3.8% net investment income tax (NIIT). See the table below.

Step-Up in Basis in a Community Property State Versus a Separate Property State		
	Community Property State	Separate Property State
Value on Date of Death	**$ 1,000,000**	**$ 1,000,000**
Cost of Jointly Purchased Stock	$ 100,000	$ 100,000
Surviving Spouse's 50% Share of Cost Basis	N/A	$ 50,000
Additional Basis	$ 900,000	$ 500,000
Basis After Step-Up in Basis	**$ 1,000,000**	**$ 550,000**
Long Term Capital Gains Tax 20%	$ 0	$ 90,000
Net Investment Income Tax (NIIT) 3.8%	$ 0	$ 17,100
Total Taxes	$ 0	$ 107,100
Proceeds Net of Taxes After Immediate Sale	**$ 1,000,000**	**$ 892,900**

Action Steps
Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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