



**Testimony of the Boston Bar Association
Before the Joint Committee on Revenue
In Support of H 2590
An Act to continue tax basis rules for
property acquired from decedents**

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The Boston Bar Association supports passage of H2590, which would provide for continuation of the “step-up” in the Massachusetts tax basis in property acquired from a decedent, a step-up that was allowed for decades under Massachusetts law, until it unexpectedly fell out of the law in 2010 due to the technical interrelation of various federal and state tax statutes. Failure to pass this bill will result in a substantial, hidden Massachusetts tax for successors to property of decedents who died in 2010, and each and every year thereafter, until the Massachusetts statute is corrected.

EGTRRA

When the federal government decided in 2001 (by way of the “Economic Growth and Tax Relief Reconciliation Act of 2001,” or “EGTRRA”) to reduce and, by 2010 (for one year only), repeal the federal estate tax, it planned to offset some expected revenue loss by eliminating, for property passing from a decedent who died in 2010 only, the so-called “step-up” in cost basis provided for in Section 1014 of the Internal Revenue Code (the “Code”). Accordingly, EGTRRA added a new Section 1014(f), which provided that Section 1014 would not apply to decedents dying after December 31, 2009.

Under EGTRRA, the estate of a 2010 decedent would pay no federal estate tax, but the decedent’s heirs would instead be responsible for paying income tax on at least

some of the pre-death capital gains (after application of certain cost-basis increases allowed under 2010 federal law) on inherited appreciated property when they sell it. This change in the federal law provided a tradeoff – capital gains taxes on pre-death gains in lieu of much higher estate taxes.

Massachusetts Response

Under pre-EGTRRA law, Massachusetts estate taxes were determined by reference to the federal “credit for state death taxes,” which EGTRRA gradually eliminated. Therefore, in response to EGTRRA, Massachusetts changed its own estate tax laws, effective for decedents dying after December 31, 2002. The effect of this change in the law, for estate tax purposes, was to provide Massachusetts with the same revenue it would have received had EGTRRA not been enacted. However, Massachusetts did not, at that time, make any changes to its rules relative to the basis of property inherited from a decedent.

Massachusetts Tax Basis Rules

Massachusetts has its own tax basis rules set forth in Chapter 62, section 6F of the Massachusetts General Laws (“MGL”). These rules interrelate heavily with the federal basis rules, but are independent of them. MGL Chapter 62, section 6F(b)(2)(C) generally provides that initial basis of property acquired from a decedent “shall be determined under section 1014 of the Code.” For Massachusetts purposes, however, this reference to Section 1014 of the Code must be read in conjunction with the definition of “Code” for purposes of MGL Chapter 62. As it applies here, the “Code” means “the Internal Revenue Code of the United States, as amended on January 1, 2005, and in effect for the taxable year.” “Code” as so defined would appear also to include Section 1014(f) (which, as discussed above, provided that Section 1014 would not apply to decedents dying after December 31, 2009).

Therefore, while property passing upon death after December 31, 2009, would be subject, for federal tax purposes, *either* to estate tax *or* to capital gains tax upon sale by legatees, because of this convoluted and technical interplay of federal and state statutes, such property is now subject to *both* taxes for Massachusetts purposes. In effect, assets that historically (both federally and for Massachusetts purposes) were subject to only one level of tax will now be subject to two levels of tax.

Example

Consider, for example, a son who inherits stock in his father's family business, worth \$1.5 million. Under the rules that existed in 2009, the father's estate would have paid \$64,400 in Massachusetts estate tax (or more, depending on the aggregate value of the father's estate), and the son would have inherited the stock with a cost basis equal to the date-of-death (or 6-month alternate) value. If the son were to sell the stock for its date of death value the day after his father died, there would be no Massachusetts capital gains tax.

Under the rules that exist in 2010 and thereafter, the father's estate would still pay \$64,400 (or more) of Massachusetts estate tax, but would inherit the stock with the father's cost basis (presumably minimal), without benefit of the "step-up." In this case, if the son subsequently sells the stock, there would be a 5.1% Massachusetts capital gains tax on \$1,000,000 of gain, resulting in \$51,000 of extra tax, for a total aggregate tax of \$115,400.

Tax Relief Act of 2010

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the "Tax Relief Act") re-instituted the estate tax for decedents who died in 2010 or thereafter. However, in order to ease the retroactive effects of the new law, the estates of those who died in 2010 were given the

option to elect either (1) application of estate tax or (2) exemption from estate tax, but with limited step-up in cost basis for capital gains tax purposes. While this new law provides some clarity regarding federal estate tax and capital gains tax laws, because applicable Massachusetts law references the Code as amended on January 1, 2005, passage of the Tax Relief Act appears to have no effect on the Massachusetts cost basis conundrum.

Consequences

This technical failure of the Massachusetts cost basis step-up creates serious complications for any taxpayer acquiring property from a decedent in 2010 or thereafter. Without any cost basis step-up, Massachusetts cost basis will be lower than federal, and Massachusetts gains will be commensurately higher. Moreover, this disconnect between death and cost basis creates a serious trap for so-called pourover trusts containing a “pecuniary” subtrust funding formula. Such a funding formula, though offering several advantages, has always imposed the potential of triggering of the recognition of gain upon funding. That problem has typically been manageable to the extent persons administering the trust are dealing only with post-mortem gains. It is a lot more serious to deal with gains accrued over the decedent’s lifetime and not reduced by the federal allocation of increased basis.

This problem does not affect only those subject to estate tax, or beneficiaries of trusts. This step-up in cost basis has fallen away with respect to everyone, regardless of net worth. Widows, widowers, children, grandchildren, and other legatees will find themselves with considerable, unexpected, and unintended capital gains tax liabilities for inherited property as a result of this accidental loss of step-up in cost basis for purposes of Massachusetts tax.

Furthermore, the complexity of the interrelationship between the various federal and state statutes outlined above allows for alternative interpretations. Some taxpayers and practitioners, noting the apparently unintentional nature of this Massachusetts double taxation, are likely to take inconsistent tax filing positions regarding whether Massachusetts law does, in fact, still allow a full step-up in cost basis. Such inconsistent filing positions likely will lead to controversies that may require costly and time-consuming court action to resolve.

H2590 states explicitly that IRC section 1014(f) is not to be given any effect for Massachusetts purposes, thereby reading IRC section 1014 back into Massachusetts law regarding cost basis for 2010 (applied retroactively) and thereafter. This long-standing Massachusetts taxation scheme – estate tax, but full step-up in cost basis – has commonly been thought of as “fair play” in mitigating the potential for double taxation. Given the Commonwealth’s continuation of its estate tax in opposition to EGTRRA and subsequent law, a corresponding continuation of the cost basis step-up rules is both consistent and fair.