YOUR STEPPED-UP BASIS POSTNUP OPINION LETTER

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You are familiar with the "Stepped-Up Basis Rule": an inherited asset receives a basis that has been increased to the asset's fair market value on the decedent's date of death.[1] The person who inherits the asset may immediately sell it without incurring capital gains taxes.

This article explains how a property-transmuting "Stepped-Up Basis Postnup" can win stepped-up basis advantages for a separatizer.

Presume these facts for the below hypotheticals:

- Separatizer Sam owns a separate property asset that he purchased for $100,000;
- Separatizer Sam and his wife Non-Separatizer Nelda have typical reciprocal estate plans in which each leaves all assets to the other; and
- Nelda predeceases Sam when the asset is worth $1,000,000.

"No Transmutation, Therefore No Stepped-up Basis" Hypothetical

Sam and Nelda did not transmute the asset from Sam's separate property to community property. The asset retains its $100,000 basis upon Nelda's death. Sam did not inherit the asset; he merely retained ownership of an asset that he already exclusively owned.

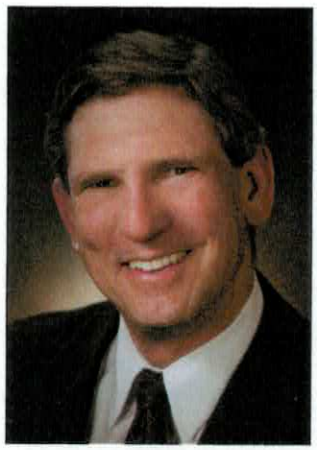
"A Transmutation, Therefore a Stepped-up Basis" Hypothetical

Sam and Nelda transmuted the asset from Sam's separate property to community property. The asset receives a $1,000,000 stepped-up basis upon Nelda's death, since Sam inherited the asset from Nelda.

(Note that *only Sam can benefit* from the separate property-to-community property transmutation. If Sam had died first, Nelda would have received the $1,000,000 stepped-up basis in the asset automatically, with no need of a transmutation having occurred. That is because, irrespective of whether the asset was separate property or community property, Nelda inherited the asset from Sam. It is important to understand that Sam—the only spouse who could be *disadvantaged* by a transmutation in event of divorce—is also the only spouse who could be *advantaged* by a transmutation in event of death.)

For decades, Estate Planning Attorney Esther often gained stepped-up basis advantages for her separatizer clients with a transmutation document she called a "community property agreement." (This article terms the transmutation document a "Stepped-Up Basis Postnup.")

Unsurprisingly, Esther stopped drafting community property agreements after publication of *In re Marriage of Holtemann*.[2] *Holtemann* decreed that the transmutation of an asset from separate property to community property *for death purposes* automatically transmuted it from separate property to community property *for divorce purposes* as well. *Holtemann* famously admonished separatizer Frank Holtemann that he could not "have his cake and eat it too."[3] If Frank wanted a financial advantage upon death, he must necessarily risk suffering a financial disadvantage upon divorce. After reading *Holtemann*, Esther wisely sidestepped the malpractice risks that those community property agreements would have produced.



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It was unfortunate, however, that all those tax-savings babies were thrown out with the malpractice-risk bathwater. As a matter of client freedom (a freedom that will be advanced by your erudite lawyering), an estate planning separatizer should be permitted to weigh guaranteed tax-savings against risk of divorce. Each time Esther avoided telling a separatizer client about the Stepped-Up Basis Rule, *she* decided that the separatizer's risk of divorce was too great for a property transmutation to be prudent.

Esther would be in a conflict of interest if she gave Sam and Nelda advice about a Stepped-Up Basis Postnup. Each spouse should have separate representation regarding any marital agreement (postnup).[4]

Furthermore, Esther lacks the expertise necessary to compare the Stepped-Up Basis Postnup's divorce risks with its estate planning advantages. What lawyer *is* competent to provide the postnup advice? What lawyer is competent to explain, for example, how, in divorce, Family Code section 2640 will retain for the separatizer the value of the asset at the time of its transmutation? *You are!* Perhaps you would like to filch a ready-made opinion letter explaining the "death pros" and "divorce cons" of a Stepped-Up Basis

Postnup. This article contains that opinion letter, so filch away.

[Editor's Note: Ron grants you permission to use the following letter any way you wish. If you would like the letter in MS Word format, email your request to ron@granberglaw.com.]

Incidentally, there has been Congressional talk of limiting (or perhaps repealing) the Internal Revenue Code § 1014 Stepped-Up Basis Rule, probably with prospective effect only. This very month Esther may be seeking a family law attorney able to educate Sam in the Stepped-Up Basis Postnup's advantages and risks—before those advantages disappear. You can help.

STEPPED-UP BASIS POSTNUP OPINION LETTER

This Is Not a Confidential Attorney-Client Communication

Dear Separatizer Sam:

Your estate planning attorney Esther has informed me that you are considering using an estate planning document called a "Stepped-Up Basis Postnup" to reduce capital gains taxes that would otherwise be owed. This letter explains the Stepped-Up Basis Postnup's goals, its potential advantages, and its potential disadvantages. After you have read this letter, please contact my office to arrange a time for us to meet. At that meeting I will explain your choices and the legal consequences (potential consequences as well as sure-thing consequences) of each choice.

You and I Have No Secrets from Nelda

Notice the statement at the top of this letter: "*This Is Not a Confidential Attorney-Client Communication.*" There are no secrets here. You are not attempting to gain any sort of advantage over your wife Nelda Non-Separatizer. To the contrary, the goal of the postnup under consideration is to minimize *your family's* capital gains tax burden. Nelda cannot end up a loser here. The Internal Revenue Service and California's Franchise Tax Board are the only targeted losers. Please show Nelda this letter.

If you and Nelda mutually decide that a Stepped-Up Basis Postnup would benefit your family, it will be necessary for Nelda to consult with an attorney other than me regarding the matter. *Nelda is specifically invited to show this letter to her attorney.* Nelda's attorney and I will work together for your family's benefit.

Explanation of Capital Gains Tax "Basis"

If a taxpayer buys an asset for a certain price, then later sells the asset for a higher price, she owes both federal and California capital gains taxes on the difference: on the taxable gain. The asset's purchase price is called its "Basis," so the formula is: "sale price *minus* Basis *equals* taxable gain."

If the taxpayer bought an asset for $100,000 then later sold it for $1,000,000, she owes capital gains taxes on the $900,000 gain. (Many details beyond the scope of this letter apply to capital gains taxation.)

Explanation of an Inherited Asset's Stepped-Up Basis

If a taxpayer inherits an asset, the asset receives an advantageous "stepped-up basis" equal to the asset's value on the decedent's date of death.

Presume that a taxpayer's father bought an asset for $100,000 and the asset was worth $1,000,000 when the father died and the taxpayer inherited it. The taxpayer receives an advantageous "stepped-up basis" of $1,000,000. If the taxpayer sells the asset the next day for $1,000,000, she owes *no* capital gains tax!

Explanation of "Characters" an Asset May Have

An asset may have one of two "characters": community property ("CP") or separate property ("SP"). Generally, assets acquired during marriage are CP. Exceptions include an asset that a spouse has inherited, which is that spouse's SP. An asset's character can be changed ("transmuted") if a couple signs a transmuting postnup. I have sent you this letter because you own SP (you are called a "Separatizer") and are planning your estate with a goal of reducing taxation. One way you could reduce capital gains taxation is by transmuting your SP to CP with a "Stepped-Up Basis Postnup." Is that a good idea? Read on.

Introduction to the Four Hypotheticals

I will use four hypothetical situations to help you understand possible capital-gains-tax-saving advantages—and possible divorce disadvantages—of a Stepped-Up Basis Postnup. Hypotheticals #1 and #2 describe the married couple Separatizer Alan and Non-Separatizer Alice, who do not have a Stepped-Up Basis Postnup. Hypotheticals #3 and #4 discuss the married couple Separatizer Barry and Non-Separatizer Barbara, who do have a Stepped-Up Basis Postnup. Because you are a Separatizer, your circumstances resemble the circumstances of Separatizers Alan and Barry. The hypotheticals are analyzed from the viewpoints of Alan and Barry.

The hypotheticals are:

Hypothetical #1	Alan and Alice in event of death
Hypothetical #2	Alan and Alice in event of divorce
Hypothetical #3	Barry and Barbara in event of death
Hypothetical #4	Barry and Barbara in event of divorce

This opinion letter explores possible:

- Advantageous divorce consequences but disadvantageous tax consequences to Alan of *not creating* a Stepped-Up Basis Postnup, and
- Advantageous tax consequences but disadvantageous divorce consequences to Barry of *creating* a Stepped-Up Basis Postnup.

Alan/Alice Hypotheticals Exclude a Stepped-Up Basis Postnup

Alan and Alice have typical reciprocal estate plans in which each leaves all assets to the other. Alan inherited Asset A back when it was worth only $100,000. Because he

inherited it, Asset A became Alan's SP. Alan and Alice never signed a Stepped-Up Basis Postnup: they never transmuted Asset A to CP.

Alan/Alice in Event of Death

Presume that Asset A is worth $1,000,000 at the time of the first spouse's death. Asset A's inherited basis depends on which spouse dies:

- If Alan dies, Alice receives Asset A with the advantageous $1,000,000 stepped-up basis. The reason is that *Alice has inherited Asset A from Alan.* If Alice sells Asset A for $1,000,000, she owes no capital gains tax.
- But if Alice dies, Alan receives Asset A with its original $100,000 Basis. The reason is that *Alan has not inherited Asset A from Alice*: he has merely kept what he already fully owned. If Alan sells Asset A for $1,000,000, he owes capital gains tax on the $900,000 gain.

Alan/Alice in Event of Divorce

If Alan and Alice divorce, Asset A is confirmed entirely as Alan's SP. Alan owes Alice nothing regarding Asset A.

Your Circumstances Resemble Alan's

You are a Separatizer like Alan. I have described Alan's circumstances to help you make your decision whether to create a Stepped-Up Basis Postnup.

Barry/Barbara Hypotheticals Include a Stepped-Up Basis Postnup

Barry and Barbara have typical reciprocal estate plans in which each leaves all assets to the other. Barry inherited Asset B back when it was worth only $100,000. Because he inherited it, Asset B became Barry's SP. Barry and Barbara have signed a Stepped-Up Basis Postnup transmuting Asset B to CP.

Barry/Barbara in Event of Death

Presume that Asset B is worth $1,000,000 at the time of the first spouse's death. Asset B's inherited Basis is stepped up to $1,000,000, irrespective of which spouse dies first:

- If Barry dies first, Barbara receives Asset B with the advantageous $1,000,000 stepped-up basis. The reason is that *Barbara inherited Asset B from Barry.* Barbara can sell Asset B for $1,000,000 and owe no capital gains tax.
- Likewise if Barbara dies first, Barry receives Asset B with the advantageous $1,000,000 stepped-up basis. The reason is that *Barry inherited Asset B from Barbara.* (Recall that the Stepped-Up Basis Postnup transmuted Asset B from SP to CP.) Barry can sell Asset B for $1,000,000 and owe no capital gains tax.

Barry/Barbara in Event of Divorce

It was on "Postnup Signature Date" that Barry and Barbara signed their Stepped-Up Basis Postnup transmuting Asset B to CP. The circumstances that will exist if Barry and Barbara divorce will depend on Asset B's value on Postnup Signature Date. The lower Asset B's value on Postnup Signature Date, the higher the sum Barbara will receive regarding Asset B in the divorce. The reason is that Barry possesses a divorce "Reimbursement Right" (technically called a "Family Code section 2640 Reimbursement Right") equal to Asset B's value on Postnup Signature Date.

Presume for discussion purposes that Asset B was worth $700,000 on Postnup Signature Date and was worth $1,000,000 on "Divorce Date": the date when Barry's and Barbara's divorce was resolved by trial or settlement. Barry's Reimbursement Right is the first $700,000 of Asset B's $1,000,000 Divorce Date value: that $700,000 belongs entirely to Barry. The remaining $300,000 (which is the amount by which Asset B increased in value between Postnup Signature Date and Divorce Date) is the parties' CP. Barry and Barbara each receive $150,000 of that $300,000 CP component. Barry ends up with ($700,000 *plus* $150,000 *equals*) $850,000, and Barbara ends up with $150,000, regarding Asset B.

Your Circumstances Resemble Barry's

You are a Separatizer like Barry. I have described Barry's circumstances to help you make your decision whether to create a Stepped-Up Basis Postnup.

Summary of Alan's Results

The *absence* of the postnup worked to Alan's *disadvantage* if Alice predeceased him. The measure of Alan's disadvantage was the amount of capital gains tax he paid on the $900,000 increase in Asset A's value.

The *absence* of the postnup worked to Alan's *advantage* if he and Alice divorced. The measure of Alan's advantage was the amount he didn't have to pay Alice in the divorce for her CP interest in Asset A.

Summary of Barry's Results

The *presence* of the postnup worked to Barry's *advantage* if Barbara predeceased him. The measure of Barry's advantage was the capital gains tax that, but for Asset B's transmutation, he would have paid on the $900,000 increase in Asset B's value.

The *presence* of the postnup worked to Barry's *disadvantage* if he and Barbara divorced. The measure of Barry's disadvantage was one-half of any increase in Asset B's value between Postnup Signature Date and Divorce Date.

We Will Meet

We will discuss in detail the contents of this letter when we meet. I promise that when you leave our meeting, you will have clear understandings of your available choices and of their respective legal effects.

Sincerely,

Family Law Attorney

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1 I.R.C. § 1014.

2 *In re Marriage of Holtemann* (2008) 166 Cal.App.4th 1166.

3 *Id.* at 1174.

4 Cal. Fam. Code., § 721; *In re Marriage of Burkle* [Burkle II] (2006) 139 Cal.App.4th 712; *In re Marriage of Haines* (1995) 33 Cal.App.4th 277; *In re Marriage of Delaney* (2003) 111 Cal. App.4th 991.