RESEARCH MEMO

Holding to the Step-Up

Why the conventional withdrawal order is wrong for a portfolio carrying large embedded gains

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Framework memo. Illustrative throughout; no client facts are described. Estate and trust treatment are legal determinations. Nothing here is tax or legal advice.

1 · SUMMARY OF CONCLUSIONS

The basis adjustment at death is the largest single tax benefit available to a taxable portfolio, and it is the one most often left out of the planning that determines whether a client captures it. It is usually discussed as an estate matter, which puts it in a different conversation from the one where the relevant decisions are actually made: which assets get spent, in what order, over the last decade or two of a client's life.

The conventional answer to that question is to spend taxable assets first, leaving tax-deferred accounts to compound, and to draw on Roth assets last. That ordering is built for a world without a step-up. In a portfolio with substantial embedded gain it is close to backwards.

> Spending taxable assets first means selling precisely the holdings whose gain would have been eliminated, while preserving the accounts that receive no adjustment at all and pass to heirs as ordinary income. The conventional order optimizes for deferral during life and ignores what happens at the end of it.

Findings

1 · The adjustment is not uniform, and the exceptions decide the plan. Taxable securities receive it. Traditional retirement accounts receive nothing and pass as ordinary income to the beneficiary. Assets held in an irrevocable grantor trust excluded from the estate receive nothing. Knowing which assets qualify is the first input, and it is frequently assumed rather than checked. (§2)

2 · Married couples in community property states receive a materially better outcome, and many do not know it. In those jurisdictions the entire community interest is adjusted at the first death, not merely the decedent's half. The difference is large, it arrives decades before most planning anticipates it, and it depends on how title is held. (§2.3)

3 · The adjustment runs in both directions. Assets carried at a loss have their basis reduced at death, destroying a loss that could have been harvested during life. The general rule that follows is simple and widely violated: harvest losses while living, hold gains until death. (§2.4)

4 · Where liquidity is needed, the order of sources matters more than the amount. Spending from cash and high-basis holdings, then borrowing where appropriate, then selling the highest-basis lots, preserves the benefit on the assets where it is worth most. A client who sells pro rata across the portfolio forfeits it indiscriminately. (§4)

5 · Gifting appreciated assets to heirs during life is dominated by holding them. A lifetime gift carries the donor's basis to the recipient. The same asset transferred at death carries a basis equal to its value. Where the motivation is to help an heir now, the asset selected should be the one with the least appreciation, not the most. (§5.2)

Three standing rules

1. **Establish which assets qualify before building a spending plan.** Account type and title determine the answer, and both are verifiable in an afternoon.
2. **Harvest losses during life; do not carry depreciated assets to death.** The step-down eliminates value that was available for free.
3. **Treat the benefit as contingent.** It rests on a provision of the code rather than on a contract, and a plan whose value depends entirely on it should be stress tested against its removal.

What would change these conclusions

- **Repeal or modification of the basis adjustment.** Proposals to replace it with carryover basis or with recognition at death appear periodically. Either would invert most of this memo and favor realization during life.

- **An estate above the exclusion amount.** Where estate tax applies, the calculus shifts from income tax efficiency to transfer tax efficiency, and techniques that remove appreciation from the estate can outweigh the basis benefit entirely. The two objectives genuinely conflict and the resolution is case-specific.
- **A client who needs the money.** None of this applies to assets that will be consumed. The framework governs the portion of the balance sheet that will outlive its owner, which for many clients is smaller than they assume.

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2 · WHAT THE ADJUSTMENT DOES AND DOES NOT COVER

2.1 The mechanism

Property included in a decedent's gross estate generally takes a basis equal to its fair market value at the date of death. Appreciation accumulated during the owner's life is never taxed to anyone. The heir who sells the following week recognizes nothing.

For a long-held position this is not a marginal benefit. A holding at 15% basis carries an embedded liability of roughly a fifth of its market value at common combined rates, and that liability disappears. No strategy discussed in any other memo in this library produces an outcome of that size.

2.2 What receives nothing

The exceptions matter more than the rule, because they are where plans go wrong.

Traditional retirement accounts. An inherited traditional IRA or employer plan carries no basis adjustment. Distributions are ordinary income to the beneficiary, generally over a compressed schedule. These are among the least efficient assets to leave behind and among the most commonly preserved, because the conventional spending order protects them.

Roth accounts pass without income tax, but they never carried a liability to eliminate. Preserving a Roth is good for other reasons; the step-up is not one of them.

Annuities and certain other deferred income assets are income in respect of a decedent and are taxed to the recipient. The embedded gain survives the owner.

Assets in an irrevocable trust excluded from the grantor's estate receive no adjustment. Revenue Ruling 2023-2 confirmed this directly. It is the trade inherent in removing appreciation from an estate: the transfer tax benefit is purchased with the income tax benefit, and for a client below the exclusion amount that trade is frequently a poor one.

2.3 Community property changes the arithmetic

In community property jurisdictions, both halves of a couple's community interest receive a basis adjustment at the first death, not only the decedent's half. In common law states, the surviving spouse's half retains its original basis.

The practical difference is substantial and it arrives early. A couple holding a long-appreciated position jointly in a community property state sees the entire embedded gain eliminated at the first death, while an otherwise identical couple elsewhere eliminates half of it and carries the remainder for the survivor's lifetime.

Two consequences follow. The benefit depends on how title is held, which means it is worth confirming rather than assuming, particularly for couples who have moved between jurisdictions or who hold assets in separate accounts. And for a surviving spouse in a community property state, the position that was a planning problem a week earlier may simply no longer be one, which should prompt a fresh look rather than a continuation of the prior plan.

2.4 The adjustment runs downward too

An asset worth less than its basis has that basis reduced at death. The unrealized loss is destroyed rather than inherited.

This is the symmetric half of the rule and it is widely overlooked, because attention concentrates on appreciated holdings. A depreciated position carried into an estate wastes a loss that could have offset gains during the owner's life or been carried forward.

The resulting discipline is straightforward. Losses should be harvested while the owner is alive, and gains should be carried. A portfolio approaching the end of its owner's life should be screened for positions below basis specifically, and those positions should be sold, with the exposure replaced if it is still wanted.

3 · WHY THE CONVENTIONAL ORDER IS WRONG HERE

The standard withdrawal sequence in retirement planning is taxable first, then tax-deferred, then Roth. The reasoning is that sheltered accounts should be left to compound as long as possible, and it is sound reasoning in a framework that stops at the owner's death.

Extend the horizon by one step and it inverts.

Spending taxable assets first means liquidating holdings whose embedded gain would have been eliminated. Preserving the traditional account means leaving behind the one asset class that receives no adjustment and arrives as ordinary income to the heir. The sequence systematically consumes the benefit and protects the liability.

The corrected ordering, for a client with substantial embedded gain who expects to leave assets behind, generally runs:

1. **Cash and high-basis taxable holdings.** Little or no benefit forfeited.
2. **Traditional account distributions, sized to the bracket.** Drawing these down during life at controlled rates is better than leaving them to a beneficiary who may be in a higher bracket and on a compressed schedule. This also reduces required distributions later.
3. **Borrowing, where the rate and the balance sheet support it.** Treated in §4.
4. **Low-basis taxable holdings.** Last, because these are where the benefit is largest.

The second item deserves emphasis because it is the reversal most likely to be resisted. Taking distributions from a traditional account earlier than required, purely to avoid leaving the account behind, feels like paying tax unnecessarily. It is instead paying tax at a known and controllable rate rather than leaving the heir to pay it at an unknown one, and it interacts directly with the conversion planning discussed in the asset location memo.

> The question is not which account is cheapest to draw from this year. It is which assets should be alive at the end, and the spending order is the instrument that decides it.

4 · FUNDING LIQUIDITY WITHOUT SELLING

Where a client needs cash and the preferred assets to sell are the ones worth holding, borrowing is the bridge.

Securities-based lending allows a client to borrow against a portfolio without liquidating it, preserving both the position and the pending basis adjustment. For a client in their later years with a large embedded gain and a defined liquidity need, the comparison is straightforward: the interest cost over the expected period against the tax cost of selling.

Where the holding period is short and the gain is large, borrowing frequently wins. Where the horizon is long or uncertain, the interest compounds and the comparison narrows.

Three constraints deserve to be stated plainly to any client considering it.

Collateral calls. A decline in the pledged portfolio can force liquidation at the worst possible moment, which is the precise outcome the strategy was built to avoid. Conservative advance rates and a genuine cushion are not optional.

Rate exposure. These facilities generally float. A borrowing plan built at one rate level can become unattractive at another, and the client bears that risk for the life of the loan.

Deductibility is not automatic. Interest treatment depends on the use of the proceeds, and borrowing to fund consumption is treated differently from borrowing to invest. This should be confirmed rather than assumed.

Pledged shares are also encumbered for other purposes. They generally cannot be gifted or transferred while the loan is outstanding, which forecloses the charitable route on those specific shares. The borrowing plan and the giving plan should be built against different parts of the portfolio.

5 · TWO COMMON ERRORS

5.1 Treating the hold as passive

Described as a strategy, holding to death sounds like the absence of one. In practice it carries the most ongoing work of any disposition, because every liquidity event over a period of years is a decision about which shares survive. A client with no plan will sell whatever is convenient, which in most portfolios means the largest position or whatever the custodian's default lot method selects.

It also means bearing concentration or single-name risk for the remainder of a life of unknown length. That is a real cost and it is borne by the client, while the benefit accrues to the heir. Worth naming explicitly in the conversation rather than leaving implied.

5.2 Gifting appreciated assets to heirs during life

A client wanting to help a child now will frequently reach for the largest position, on the reasoning that it is the most valuable thing to give. The basis follows the asset.

A lifetime gift of appreciated securities transfers the donor's basis to the recipient, who inherits the embedded liability along with the asset. The same securities transferred at death would have carried a basis equal to their value and no liability at all. The gift has converted an eliminated gain into a deferred one.

Where lifetime transfers are the objective, the asset to select is cash or a high-basis holding, and the appreciated position should stay where it is. Where the recipient is a charity rather than an individual, the logic reverses entirely, because a charity recognizes nothing on sale. The charitable memo treats that case.

6 · WHERE THIS FRAMEWORK DOES NOT APPLY

A client who will spend the portfolio. The step-up governs assets that outlive their owner. For a client drawing down a portfolio to zero, it is irrelevant and the conventional withdrawal order may well be correct.

An estate facing transfer tax. Above the exclusion amount, removing appreciation from the estate can be worth more than preserving the basis adjustment on it. These objectives are in genuine tension and the resolution depends on the size of the estate, the growth rate of the asset, and the time horizon. It is a planning question for counsel, not an investment one.

High-basis portfolios. Where little gain is embedded, there is little to eliminate, and spending order should be driven by bracket management instead.

A client whose risk tolerance does not support the hold. Carrying a concentrated or volatile position for decades to secure a benefit the client will never personally receive is a defensible plan only where the client genuinely understands and accepts it. Where they do not, the correct answer is to sell and pay the tax.

Framework memo prepared for illustrative purposes. Not tax or legal advice. Estate inclusion, trust treatment, community property characterization, and interest deductibility are legal determinations that depend on individual circumstances and applicable state law, and should be confirmed with qualified counsel. The basis adjustment described here is a feature of current law and is subject to legislative change.

Part of a Series

This memo is one of a set on concentrated positions. The framework that determines which tool applies is in Concentrated Positions.