Take advantage of a “stepped-up basis” when you inherit property

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If you’re planning your estate, or you’ve recently inherited assets, you may be unsure of the “cost” (or “basis”) for tax purposes.

Fair market value rules

Under the fair market value basis rules (also known as the “step-up and step-down” rules), an heir receives a basis in inherited property equal to its date-of-death value. So, for example, if your grandfather bought ABC Corp. stock in 1935 for $500 and it’s worth $5 million at his death, the basis is stepped up to $5 million in the hands of your grandfather’s heirs — and all of that gain escapes federal income tax forever.

The fair market value basis rules apply to inherited property that’s includible in the deceased’s gross estate, and those rules also apply to property inherited from foreign persons who aren’t subject to U.S. estate tax. It doesn’t matter if a federal estate tax return is filed. The rules apply to the *inherited* portion of property owned by the inheriting taxpayer jointly with the deceased, but not the portion of jointly held property that the inheriting taxpayer owned before his or her inheritance. The fair market value basis rules also don’t apply to reinvestments of estate assets by fiduciaries.

Step up, step down or carryover

It’s crucial for you to understand the fair market value basis rules so that you don’t pay more tax than you’re legally required to.

For example, in the above example, if your grandfather decides to make a gift of the stock during his lifetime (rather than passing it on when he dies), the “step-up” in basis (from $500 to $5 million) would be lost. Property that has gone up in value acquired by gift is subject to the “carryover” basis rules. That means the person receiving the gift takes the same basis the donor had in it (just $500), plus a portion of any gift tax the donor pays on the gift.

A “step-down” occurs if someone dies owning property that has declined in value. In that case, the basis is lowered to the date-of-death value. Proper planning calls for seeking to avoid this loss of basis. Giving the property away before death won’t preserve the basis. That’s because when property that has gone down in value is the subject of a gift, the person receiving the gift must take the date of gift value as his basis (for purposes of determining his or her loss on a later sale). Accordingly, a good strategy for property that has declined in value is for the owner to sell it before death so he or she can enjoy the tax benefits of the loss.

These are the basic rules. Other rules and limits may apply. For example, in some cases, a deceased person's executor may be able to make an alternate valuation election. And assets classified as "income in respect of a decedent" (e.g., qualified and non-qualified retirement plans; IRAs; salary, dividends and rent not paid before death) don't receive a step-up/step-down in basis to preserve the inherent income tax consequences (ordinary income) to the recipient (estate or beneficiary) on receipt of such assets.

Please contact us for tax assistance when estate planning or after receiving an inheritance.

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