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Balance sheet

Inherited Property: Basis Rules

By Mark L. Schroeder, CPA

What is the "cost" for tax purposes (or "basis") for an individual who inherits property from another? This is an important area that is too often overlooked when families start to put their affairs in order.

Under the fair market value basis rules (also known as the "step-up and step-down" rules), the heir receives a basis in inherited property equal to its date-of-death value. So, for example, if A bought X Corporation stock in 1935 for $500 and it is worth $5 million at A's death, the basis is stepped up to $5 million in the hands of A's heirs and all of that gain escapes income taxation forever.

The fair market value basis rules apply to inherited property that is includible in the deceased's gross estate, whether or not a federal estate tax return was filed, and those rules also apply to property inherited from foreign persons, who are not subject to U.S. estate tax. 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 do not apply to reinvestments of estate assets by fiduciaries.

It is crucial for you to understand the fair market value basis rules so that you do not pay more tax than you are legally required. For example, if, in the above example, A, instead of owns the stock upon death, decides to make a gift of it in honor of A's 100th birthday, 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: the donee 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," instead of a "step-up," occurs if a decedent 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. In this case, however, giving the property away before death will not preserve the basis: when property that has gone down in value is the subject of a gift, the donee must take the date of gift value as his basis (for purposes of determining his loss on a later sale). The best idea for property that has declined in value, therefore, is for the owner to sell it before death so he can enjoy the tax benefits of the loss.

Alternate valuation. Although the above discussion refers to the date-of-death value, the value is different in some cases. Where the decedent's executor makes the alternate valuation election, then basis will be determined as of the date six months after the date of death (or, if the property is distributed or otherwise disposed of by the estate within the six-month period, the date of distribution or other disposition).

If you have any questions on this topic, please contact our office.

Items presented are not intended to be technically complete. Additional information may be required to make an informed decision. You cannot rely upon this information for avoiding tax penalties.