



STEP-UP IN BASIS

An Income Tax Concept that Affects You and Your Family

What is "Step-Up in Basis"? How will it benefit me while I am alive and my family after I am gone? And what can I do to maximize the benefits of this tax concept?

Section 1014 of the Internal Revenue Code ("IRC") requires a "basis" adjustment to assets which are includible in a decedent's taxable estate for federal estate tax purposes - even if no estate tax return is required to be filed. Think of "basis" as "cost" for calculating capital gain on sale.

Example: John dies and leaves his Apple stock to his daughter. John paid \$50,000 for the stock, but on his date of death the stock has a fair market value of \$200,000. Had John sold the stock before he died, he would have had a \$150,000 capital gain (with a potential tax liability of \$30,000 or more).

But if his daughter sells the stock after John dies, her cost (i.e. basis) for calculating capital gain is \$200,000. So, if she sells it for \$201,000, she will only have a \$1,000 capital gain. If she sells it for \$199,000, she will have a \$1,000 capital loss.

Gifted property (transferred before the owner's death) does not get a basis adjustment. So, if John gave the stock to his daughter shortly before his death, her basis would be his basis

(\$50,000), and would not be increased upon his death. That is why we usually recommend NOT gifting appreciated property when death may be imminent.

Basis adjustment is used not only for calculating capital gain upon sale, but also for calculating depreciation on depreciable assets such as a rental property.

Example: Instead of stock, assume the asset described above was a rental property that John acquired many years ago for \$50,000 and has fully depreciated the value down to \$10,000 (his basis before death.)

His daughter's initial reaction was that she didn't care about step-up in basis because she never plans to sell the property. But if she "inherits" the property as a result of John's death, she can start deducting depreciation (estimated at \$5,400 per year) based upon the fair market value on John's date of death.

It should be noted that a step up in basis does not apply to IRAs and other retirement plan assets, deferred annuities, the deferred interest build-up in U.S. Savings Bonds, and certain other assets.



Moreover, there is also a step DOWN in basis for assets that have decreased in value. That is why we frequently recommend selling assets which have lost value before death, as the taxpayer can at least partially deduct the capital loss against capital gains and ordinary income.

For joint tenancy property, the rule for married couples is that 50% of the property is includible in the taxable estate of the first to die, and therefore, basis adjustment applies only to that 50%. Of course, when the surviving spouse dies, the entire property is includible in his/her taxable estate, and therefore, there is a second basis adjustment - this time on the entire property.

For non-married joint tenants, the rule looks at contribution. If the decedent paid for the property then added his daughter's name and held the asset in joint tenancy upon his death, there is a basis adjustment to 100% of the property. If the daughter dies first, there is no basis adjustment.

Perhaps you are thinking that a healthy spouse could transfer the appreciated assets to the dying spouse and "inherit" the assets with a step-up in basis. Unfortunately, IRC Section 1014(e) provides that there is no basis increase when gifted assets are inherited by the donor within one year of the transfer. So, if you think you may have more than a year, it might be worth taking a chance on who may die first.

Colorado is NOT a community property state. "Community Property" is a bundle of ownership rights mandated by state law between married couples. There are ten community property states (LA, TX, NM, AZ, CA, NV, WA, ID, AK, and WI).

Under IRC 1014(b)(6) there is a 100% basis adjustment on the first death on community property. We mention this because many people move to Colorado from a community property state, and Colorado does recognize community property for those states when married couples move to this state. Similarly, some community property states permit couples moving there from Colorado to convert their separate or common law property to community property.

To summarize, to determine what property is subject to a "basis adjustment", we must first look at the type of property involved - is it even subject to basis adjustment? Next, we must determine if the property was included in the decedent's taxable estate for estate tax purposes.

Lastly, we must determine the fair market value on date of death. The IRS has specific regulations covering each of these issues, and this fact sheet provides only a brief summary of those rules.

This Memo is offered as an informational summary only and does not discuss complete tax, legal, and other aspects of step-up in basis, nor all the drafting options. You should consult with a legal or financial professional before acting on the advice contained herein.

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