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Estate Planning and Income Tax Basis

Income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

This discussion contains examples that include references to stock that has increased in value for purposes of explaining basis rules. It is important to understand that any shares of stock can lose some or all of their value over time.

Income tax basis can be an important factor in deciding whether to make gifts during your lifetime or transfer property at your death. This is because the income tax basis for the person receiving the property depends on whether the transfer is by gift or at death. This, in turn, affects the amount of taxable gain subject to income tax when the person sells the property.

What is income tax basis?

Income tax basis is the base figure you use when determining whether you have recognized capital gain or loss on the sale of property for income tax purposes. When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis. If you sell the property for more than your adjusted basis, you'll have a gain. Sell the property for less than your adjusted basis, and you'll have a loss.

Example: *You purchased stock for $25,000. Your basis in the stock is $25,000. If you sell the stock for more than $25,000, you would have gain. If you sell the stock for less than $25,000, you would have a loss.*

What is the income tax basis for property you receive by gift?

When you receive a gift, you generally take the same basis in the property that the person who gave you the property (the donor) had. (This is often referred to as a "carryover" or "transferred" basis.) The carried-over basis is increased--but not above fair market value (FMV)--by any gift tax paid that is attributable to appreciation in value of the gift (appreciation is equal to the excess of FMV over the donor's basis in the gift immediately before the gift). However, for purpose of determining loss on a subsequent sale, the carried-over basis cannot exceed the FMV of the property at the time of the gift.

Example: *Say your father gives you stock worth $1,000. He purchased the stock for $500. Assume the gift incurs no gift tax. Your basis in the stock, for purpose of determining gain on the sale of the stock, is $500. If you sold the stock for $1,000, you would have gain of $500 ($1,000 received minus $500 basis).*

Now assume that the stock is worth only $200 at the time of the gift, and you sell it for $200. Your basis in the stock, for purpose of determining gain on the sale of the stock, is still $500; but your basis for purpose of determining loss is $200. You do not pay tax on the sale of the stock. You do not recognize a loss either. In this case, your father could have sold the stock (and recognized the loss of $300--his basis of $500 minus $200 received) and then transferred the sales proceeds to you as a gift. (You are not permitted to transfer losses.)

Example: *Assume your father gives you real estate worth $1,000,000. He purchased the land for $200,000. Assume your father paid gift tax of $400,000 on the transfer. Your basis in the land, for purpose of determining gain (or loss) on the sale of the land, is $520,000 [$200,000 + $400,000 x (($1,000,000 - $200,000) / $1,000,000)]. If you sold the land for more than $520,000, you would have gain. If you sold the land for less than $520,000, you would have a loss.*

Now assume your father gives you real estate worth $1,000,000, but he purchased the land for $1,200,000. Assume your father paid gift tax of $400,000 on the transfer. Your basis in the land, for purpose of determining gain (or loss) on the sale of the land, is $1,000,000. In this case, your father could have sold the land (and recognized the loss of $200,000--his basis of $1,200,000 minus $1,000,000 received) and then transferred the sales proceeds to you as a gift.

What is the income tax basis for property you inherit?

When you inherit property, you generally receive an initial basis in property equal to the property's FMV. The FMV is established on the date of death or,

The generation-skipping transfer (GST) tax is a separate tax that generally applies when you transfer property to a person two or more generations younger than you, such as a grandchild. In some circumstances, GST tax can affect basis.

sometimes, on an alternate valuation date six months after death. This is often referred to as a "stepped-up basis," since basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

Example: *Say your mother leaves you stock worth $1,000 at her death. She purchased the stock for $500. Your basis in the stock is a stepped-up basis of $1,000. If you sold the stock for $1,000, you would have no gain ($1,000 received minus $1,000 basis).*

Now assume that the stock is worth only $200 at the time of your mother's death. Your basis in the stock is a stepped-down basis of $200. If you sold the stock for more than $200, you would have gain.

Transfers within one year of death. If you transfer appreciated property to a person within one year of his or her death, and then you (or your spouse) receive the property back at that person's death, the basis in the property is not stepped up or down to FMV. Instead, the basis in the property is equal to that person's basis immediately before death. (And this basis is probably pretty close to the basis you originally had in the property before you transferred it.)

This rule is designed to prevent you from obtaining a stepped-up basis by transferring appreciated property to a dying person who then transfers it back to you (or your spouse) at death. However, the rule does not apply if the dying person lives for more than one year after you transfer the property to him or her. Also, the rule does not apply if the property passes from the decedent to someone other than you or your spouse (e.g., to one of your children). In those cases, a stepped-up basis would be available.

Income in respect of a decedent (IRD). There is no step up (or step down) in basis for IRD. IRD is certain income that was not properly includable in taxable income for the year of the decedent's death or a prior year. In other words, it is income that has not yet been taxed. Examples of IRD include installment payments and retirement accounts.

When you inherit IRD, you include the IRD in income as you receive payments, and take any related deductions. An income tax deduction may be available for any estate tax paid that's attributable to the IRD.

How does generation-skipping transfer (GST) tax affect basis?

As discussed above, when you make a gift, the carried-over basis is increased--but not above FMV--by any gift tax paid that is attributable to appreciation in value of the gift. If the gift is also subject to GST tax, the carried-over basis is then increased--but not above FMV--by any GST tax paid that is attributable to appreciation in value of the gift.

Special rules can apply when property in a trust passes at the death of an individual.

Make gift now or transfer at death?

As the following example shows, income tax basis can be important when deciding whether to make gifts now or transfer property at your death.

Example: *You purchased land for $25,000. It is now worth $250,000. You give the property to your child (assume the gift incurs no gift tax), who then has a tax basis of $25,000. If your child sells the land for $250,000, your child would have taxable gain of $225,000 ($250,000 sales proceeds minus $25,000 basis).*

If, instead, you kept the land and transferred it to your child at your death when the land is worth $250,000, your child would have a tax basis of $250,000. If your child sells the land for $250,000, your child would have no taxable gain ($250,000 sales proceeds minus $250,000 basis).

In addition to income tax basis, you might consider the following questions:

- Will making gifts reduce your combined gift and estate taxes? For example, future appreciation on gifted property is removed from your gross estate for federal estate tax purposes. And gift tax paid on gifts made more than three years before your death is also removed from your gross estate.
- Does the recipient need a gift now or can it wait? How long would a recipient have to wait until your death?
- What are the marginal income tax rates of you and the recipient?
- Do you have other property or cash that you could give?
- Can you afford to make a gift now?