

Inherited property: basis rules

Many have asked what "cost" for tax purposes (or "basis") an individual gets in property he inherits from another. This is an important area and is too often overlooked when families start to put their affairs in order.

The general rule is referred to as the "step-up" basis rule. That is, the heir receives a basis in inherited property equal to its date of death value. So, for example, if Uncle Harry bought Kodak 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 his heirs and all of that gain escapes income taxation forever.

The step-up basis rule applies to inherited property that's includible in the deceased's gross estate, whether or not a federal estate tax return was filed, and it also applies to property inherited from foreign persons, who aren't subject to U.S. estate tax. The rule applies 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 inheritance. The step-up basis rule also doesn't apply to reinvestments of estate assets by fiduciaries. Note also that for property inherited from individuals dying after 2009, the amount of property appreciation to which a step-up basis will apply will be subject to various dollar limitations.

It's crucial for the step-up basis rule to be understood so that disastrous tax errors are not made.

For example, if, in the above example, Uncle Harry, instead of dying owning the stock, decided to make a gift of it in honor of his 100th birthday, the step-up in basis 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.

The basis "step-up" rule can become a "step-down" rule as well. That is, if a decedent dies owning property that has declined in value, its 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 which 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 which 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 rule 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).

Death bed maneuvers. One ploy the tax rules sought to prevent was the passing of property through a decedent to attempt to inflate basis under the above rules. For example, say Tim owns stock with a \$1,000 basis and \$20,000 value. He goes to 97-year old Uncle Vern and arranges the following: Tim makes a gift of the stock to Uncle Vern, who takes it with Tim's \$1,000 basis. Vern then dies leaving the stock back to Tim in his will. Tim regains ownership, but now with the basis stepped up to its \$20,000 date of death value. Under the tax rules, if Uncle Vern dies within a year of when Tim made the

gift, Tim still has his original (\$1,000) basis. The result is the same if, instead of leaving the stock to Tim, Uncle Vern leaves the stock to Tim's wife.