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Basis: Carryover or Stepped-Up

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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.

Carryover basis

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.

Stepped-up basis

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, 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.

Basis is not stepped up or down to FMV for certain property transferred to the decedent within one year of death and for income in respect of a decedent (certain income, such as a retirement account, that was not properly includable in taxable income for the year of the decedent's death or a prior year).

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).

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