

## 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 is because the income tax basis of 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. (Gain or loss on the sale of property equals the difference between your adjusted tax basis and the amount you realize upon the sale of the property.) When you purchase property, your basis is generally equal to the purchase price. However, there may be some adjustments made to basis.

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

When you receive a gift, you generally take the donor's basis in the property. (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 the 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 only worth \$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 should 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.)

### 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 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 only worth \$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.

### 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.
- 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?