Financial Planning Topic of the Month

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Determining Cost Basis of Inherited Property

If you have long-term investments, you may have large, embedded gains that can cause a pretty high tax bill. However, even though you cannot escape paying taxes on these gains, your heirs may avoid tax liability when they inherit certain assets. This gives your heirs a huge tax advantage because their cost basis is essentially reset.

Only certain types of assets have capital gains when sold. The most common types include a primary home and an individual account. An asset's cost basis is normally the purchase price. If an asset is sold above its cost basis, the difference is the capital gain, and you only pay tax on that capital gain portion.

If you hold stocks/bonds in an individual account, you can qualify for long-term capital gain tax rates if the stock/bond is held for at least one year. The capital gain tax bracket you fall in is determined by your taxable income. The rates include 0%, 15%, and 20%. A majority of people fall into the 15% capital gain tax bracket, which is probably lower than what your ordinary income bracket

would be.

When assets pass to your heirs, they receive a stepped-up cost basis as of the date of death. For example, say you opened an individual account, and your total investment (cost basis) over your working life was $100,000. At the end of your life, the account grew to $350,000 and is passed on to your heirs. This means your heir's cost basis would be $350,000, and there are no capital gains. If your heir chose to sell everything in the account right after inheriting it, they would owe no taxes.

However, if your heir chose to let the account grow instead, capital gains would accumulate over time as the account value increases. Any gain will be treated as a long-term capital gain, regardless of how long the heir held the stock before the sale. This is another huge advantage to the beneficiary inheriting the account because they will always qualify for those lower tax rates.

A very important distinction is that these rules do not apply to assets that were gifted prior to a death occurring. For example, you cannot gift stocks/bonds and have the person receiving the gifts receive a stepped-up cost basis. The tax rules work completely different for gifted assets. A general rule of thumb is gifted assets assume the same cost basis as the original owner. Of course, there are always exceptions, but this is most common.

It's important to have a clear understanding of how these cost-basis rules work. Tax laws like this can have a huge impact on your withdrawal strategy in retirement and your estate planning. Understanding these types of tax laws not only provides major tax benefits to your heirs but can increase your chances of success for your financial health.

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