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What is the "Basis Step Up Rule" in Estate Tax?

Have you heard of the “Basis Step Up Rule”? This is arguably one of the tax provisions in the tax code that is least known and least taken advantage of. But if you understand what this rule is, you can potentially save tens of thousands of dollars in capital gains tax. Let me explain.

The “Basis Step Up Rule” has to do with inherited property. Obviously, inherited property in turn has to do with estate duty tax. When a taxpayer passes away, the government may tax his or her estate with the estate duty tax, also known as the “Death Tax”. However, estate duty tax only applies if your estate is worth more than $5 million at the time of death. This provision applies till the end of the 2012 tax year. It is important to bear in mind this ceiling of $5 million because it has an effect on the “Basis Step up Rule”. This is how the “Basis Step up Rule” works. Basically, the rule allows the heir of any inherited property to base any capital gains tax when a property is sold on the market value of the property at the time of death (i.e. the time the property is passed down) and not at the time the property was purchased.

Suppose John Doe buys a house for $100,000 in 1980. He passes away this year (2011) and in his will, he passes the ownership of the house to his son, Joe. If Joe subsequently sells the house, he ought to be subjected to capital gains tax. But with the “Basis Step up Rule”, this capital gains tax could be lowered to zero. The “Basis Step Up Rule” allows the house to be appraised according to current market value at the time of death. Suppose the house is now worth $250,000 in 2011. If Joe were to sell it at $260,000 he would only have to pay capital gains tax on the $10,000 profit ($260,000 – $250,000) and not on $150,000 (i.e. the selling price of $250,000 in 2011 – the purchase price of $100,000 in 1980).

Now if Joe sells the property at the price of $250,000 (the price it is appraised at the time of death), then Joe pays zero capital gains tax. Needless to say, this rule results in hefty savings in taxes.

This means that the appraisal of the property at the time of death is very important. Without a clear understanding of estate duty tax, an appraiser may value the property wrongly. Using the example above, suppose an inexperienced appraiser values the house Joe inherits at $200,000 instead of $250,000 to lessen the overall estate duty tax due on John Doe’s estate. Then if Joe sells the house for $260,000, then he has to pay capital gains tax on $60,000 (instead of $10,000 like in the example above).

This is why it is important to bear in mind the $5 million ceiling in estate tax. If John Doe's estate is not worth anywhere near $5 million even if the house is valued at $250,000 (its actual market value), then the appraiser should declare its value as $250,000. And even if John Doe's estate is worth more than $5 million if the house is valued at $250,000, it is worth calculating if the estate duty payable is more than the capital gains tax payable if the house is sold at $260,000.

That is why it is important to consult a tax attorney in cases like this so that you can receive the best advice that will save you the most amount of money in taxes.

If you need help in sorting out your estate taxes to take full advantage of the "Basis Step Up Rule", call us at (813) 229 7100 for a free consultation.