

What Is a Step-up in Basis?

By: Exchange Capital Management

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Receiving an inheritance is often overwhelming. Alongside the sorrow of losing a loved one, you often also inherit the responsibility of transitioning their assets. Merging inherited assets into your financial plan involves navigating complex rules and regulations. One crucial aspect to consider is the potential tax implications associated with an inheritance. Fortunately, the tax code includes a helpful provision called a step-up in basis, which reduces the tax liability you may inherit.

Understanding a Step-up in Basis

To grasp the concept of a step-up in basis, it's essential to understand the notion of cost basis. In its simplest form, the cost basis is what you paid for an investment. As time passes, the investment may increase in value, otherwise known as an unrealized capital gain. These gains are not subject to taxes until the asset is sold, at which point they become realized capital gains.

When you receive an inheritance, there may be a step-up in the investment's cost basis. This means the cost basis is adjusted to the Fair Market Value (FMV) at the date of the owner's death, rather than the original purchase price. By receiving a step-up in basis, you can reduce or eliminate your capital gains tax liability when you sell the inherited investment.

To illustrate, imagine this scenario: your parents purchased the cherished family cottage for \$100,000. Fast forward to the day they pass away, and the cottage's market value has soared to \$1,000,000. When you eventually decided to sell it, the value climbed even further to \$1,200,000.

Now, here's where the step-up in basis comes into play: your cost basis gets adjusted to match the market value at the time of their passing, which is \$1,000,000. As a result, you only have to pay taxes on the capital gain of \$200,000. The remarkable advantage lies in the fact that the \$900,000 increase in value, which would have originally incurred taxes for your parents, simply vanishes.

The Bottom Line

Understanding the concept of a step-up in basis is crucial for managing inherited assets and minimizing tax obligations. By adjusting the cost basis to the FMV at the time of passing, beneficiaries can reduce capital gain taxes by hundreds of thousands of dollars.