BAIRD
Private Wealth Management

Basis Adjustments at Death

Describes the rules for adjusting the cost basis of property upon the owner's death, i.e., a step-up (or a step-down), including the rules for joint property, income in respect of a decedent (IRD), an alternate valuation

Estate Planning Department
Estateplanning@rwbaird.com

General rule. The basis of property "acquired from a decedent" is adjusted to the "fair market value" of that property at the date of death (unless one of the exceptions outlined below applies). Basis adjustments at death, whether *up or down*, are **required**, not optional.

1. **Property acquired from a decedent**. Property acquired from a decedent includes virtually any type of property deemed to have been owned by the decedent at death, including probate and non-probate property, real and personal property, tangible and intangible property, etc.

   Example 1: A decedent died owning the following: (1) an individual brokerage account, (2) a brokerage account held in a Revocable Living Trust, (3) several securities held in certificate form, and (4) a personal residence titled in his individual name. All of the assets described above receive a new basis equal to their date of death values.

   Example 2: In addition to the facts described above in Example 1, the decedent died possessing an income interest for life (a life estate) in a trust created under his mother's estate at her earlier death. The trust remainder passes equally to the decedent's children. The basis of these trust assets do <u>not</u> get adjusted because they do not pass "from the decedent." The property really passed from the decedent's mother and while the basis should have been adjusted at her death, it is not adjusted again at her son's death.

2. **Where no U.S. Estate Tax Return is due**. Property acquired from a decedent receives a new basis even if no state or federal estate tax was incurred at the decedent's death (i.e., because the total value of the decedent's estate was less than the applicable state and federal estate tax exemption amounts).

   Example: In 2020, when the federal estate tax exemption is $11,580,000, an individual dies with an estate that totals $2,000,000 in value. Even though his estate falls below the $11,580,000 filing requirement for a U.S. Estate Tax Return, all of the decedent's property receives a basis adjustment at his death.

3. **Types of Securities.** The rules for adjusting the basis of assets acquired from a decedent are slightly different for different types of securities.

   a. **Stocks and bonds**. Stocks are adjusted to the mean (average) between the high and low trading prices on the date of death.

      Example: High 34, Low 33 → Mean 33.5

Baird does not provide tax advice. Please consult with your tax advisor.

Weekends and Holidays. When the date of death falls on a weekend or holiday, the basis of stocks and bonds is adjusted to the average of the mean between the high and low trading prices on the days immediately before, and immediately after, the weekend or holiday.

b. Mutual Funds. Since there are no intra-day quotes for mutual funds, the basis of mutual funds is adjusted to the closing selling price on the valuation date.

Weekends and Holidays. When the date of death falls on a weekend or holiday, the basis of a mutual fund is adjusted to the closing price on the first trading day preceding the date of death.

4. **Exceptions to the General Rule**. There are several exceptions to the general rule that assets acquired from a decedent are adjusted to the date of death value. They include:

a. Alternate Valuation. If "Alternate Valuation" is elected by the executor or personal representative, the same rules outlined above are applicable, but they are applied with respect to the high-low trading prices as of the date that is **six months after the date of death.**

i. **Election must reduce federal estate taxes**. Alternate valuation can only be elected where the gross estate and the federal estate tax are both reduced as a result of the election. In other words, this election is **not available for smaller estates** that are not large enough to be subject to federal estate tax (i.e., estates that are below the current $11,400,000 federal estate tax exemption amount). Similarly, estates of decedents survived by a spouse will often not qualify for alternate valuation because estate plans of married couples will generally be designed to defer all estate taxes until the death of the surviving spouse.

ii. **Global Election**. If alternate valuation is elected, **all** estate assets are subject to the alternate valuation rules (i.e., there is no "picking and choosing" among assets.

iii. **Property sold, exchanged or distributed**. An alternate valuation election causes the value of estate assets to be established six months after the date of death, *unless* individual assets are *sold, exchanged, or distributed* sooner, in which case their respective estate tax value (and basis) is established at such earlier date of sale, exchange, or distribution.

b. Income in Respect of a Decedent ("IRD"). Items of "income in respect of a decedent" are not entitled to a basis adjustment at the decedent's death. Examples of such IRD items include IRAs, 401(k)s, tax-deferred annuities and other qualified retirement assets.

5. **Other Basis Issues:**

a. Transfer on Death (TOD) Accounts. All of the assets held in a TOD account receive a new basis at the account owner's death. (Ideally, the assets will be registered in a new account in the name of the designated beneficiaries before any securities are sold.)

b. Assets jointly-owned by Husband and Wife. The basis adjustment rules for property owned jointly by a married couple will be different for Common Law and Community/Marital Property states.

i. **Common Law States**. Assets owned jointly by Husband and Wife in all common law states are deemed *Qualified Joint Interests* and only *one-half* of the assets receive a basis adjustment on the first spouse's death (regardless of which spouse contributed the original property to the joint account).

Example. Husband and Wife, who are residents of a common law state (FL), purchase 100 shares of stock for $10 per share in a jointly-owned account. Later, at the death of one spouse, the stock has increased in value to $20 per share. Only ½ of the jointly-owned stock receives a basis adjustment. Notice also that the executor or personal representative could keep the 100-share lot intact and adjust the basis of each individual share to $15, however, it may be more practical to divide the original 100 share lot into two separate 50-share lots. As a result, one 50 share lot (the decedent's ½ interest) has a FMV of $20 per share, with an adjusted basis of $20 per share. A second 50-share lot (the surviving spouse's ½ interest) also has a FMV of $20 per share, but with a basis (the original cost) of $10 per share. This *bifurcation* of the original 100 shares may facilitate post-mortem planning because the decedent's (adjusted) lot may now be sold without incurring any capital gains tax.

ii. **Community/Marital Property States**. In 8 (mostly western) Community Property states (AZ, CA, ID, LA, NM, NV, TX, and WA) and Wisconsin, which has a similar Marital Property system, assets owned jointly by Husband and Wife will generally receive a *full* basis adjustment on both halves of their community or marital property at the death of either spouse. This is a unique tax advantage available only to married couples domiciled in these states.

Example. Husband, a Wisconsin resident, owns 100 shares of XYZ Corp. in his individual brokerage account. Although only 50 shares represent Husband's marital share and pass under the terms of his will, the 50 shares representing Wife's marital property share also receive a basis adjustment at her Husband's death.

c. Assets jointly-owned by non-spouses. The basis adjustment of non-spousal jointly-owned property requires a **tracing** of who provided the original consideration for the assets held in the joint account. One of the following three scenarios will apply in these cases"

i. **Decedent contributed 100%**. If the decedent provided 100% of the original property in the account (and only added a joint-owner for convenience and/or to facilitate a non-probate transfer of the property at death), 100% of the jointly-owned assets receive a new basis at death.

ii. **Survivor contributed 100%**. On the other hand, if the *surviving* co-owner provided 100% of the original property in the account, 0% of the jointly-owned assets receive a new basis at the death of the co-owner who did not contribute to the original purchase of property in the account.

iii. **Both co-owners contributed**. The percentage of contribution determines the percentage that is adjusted. For example, if two sisters pool their resources and each contributes *equally* to the creation and funding of a joint account, then one-half of the assets held in the joint account will receive a new basis at the death of either of the co-owners.

d. A-B Trusts. When one spouse dies and his/her estate is divided between a "B Trust" (aka Family Trust, By-pass Trust, or Credit Shelter Trust) and an "A Trust" (aka Marital Trust, or QTIP Trust), all of the decedent's property gets a basis adjustment when the A and B Trusts are initially created and funded, but when the surviving spouse subsequently dies, only the A Trust gets a second basis adjustment. The assets in the B Trust do not get another basis adjustment when the surviving spouse subsequently dies (because the B Trust assets "pass" from the estate of the first spouse to die, not from the estate of the surviving spouse).

e. No basis adjustment where decedent had acquired property by gift within one-year of death if property is left to donor or donor's spouse. If a decedent had received appreciated property by gift during the 1-year period ending on his date of death, and that same property passes from the decedent to the donor of that property (or to the donor's spouse), that property will not receive a basis adjustment by reason of the decedent's death.

Example. Son, who owns 100 shares of highly-appreciated stock in XYZ, Corp., gifts the stock to his 90-year old ailing Mother. Mother dies within one-year of the gift, leaving her entire estate, including the XYZ, Corp. stock, to Son. Son is not entitled to a basis adjustment in the XYZ stock. (The same result would apply if Son gifted the stock to his ailing Mother-in-Law, who died within one-year of the gift and left the stock to Son's spouse.)

f. **Post-Death Capital Gains and Losses**. All capital gain (or loss) that occurs after the owner's death is automatically deemed long-term capital gain (or loss) if the property sold was included in the decedent's gross estate (regardless of the length of the post-death holding period).

Example. 100 shares of XYZ, Corp. are included in a decedent's estate and receive a new basis of $50 per share as of the date of death. If the estate sells the stock one month after the date of death for $55 per share, the estate recognizes a $5 long-term capital gain for each share sold (even though the estate's holding period was less than one year).