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# Income Tax Impact While Selling, Gifting, or Leaving Property as an Inheritance

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Before reaching a decision to sell, give, or leave property as an inheritance, owners should become aware of the income tax concepts of **basis** and **adjusted basis**. Property owners should also know the difference between the **stepped-up basis** on inherited property and the **carryover basis** on property the owner gifts during lifetime. This MontGuide will expand on the above concepts and illustrate the potential tax consequences.

Sarah has not made any improvements on the land since she purchased it. The **adjusted basis** of her land is \$47,500. If Sarah sells the land for \$1.5 million, she will have a long-term capital gain of \$1,452,500. Her certified public accountant computed the gain by subtracting the \$47,500 adjusted basis from the \$1.5 million sale price. He then informed Sarah she would owe three different taxes if she sold her land. See **Table 1**.

## What is the meaning of BASIS?

**Basis** is the taxable value of property. **Basis** begins with the cost of the property when the owner first obtained it. The value of some property typically increases. Examples include homes and land. On the other hand, we have all heard of stock and mutual funds which have increased or decreased in value.

The **adjusted basis** on real property (land and whatever is built on, growing on or affixed to it, such as fences or buildings) is the price an owner paid for it adjusted by depreciation, amortization, casualty losses and the cost of any added improvements, such as a garage, at the time the owner made the improvements. An owner uses the **adjusted basis** to calculate any gain or loss on the value of property upon a sale.

## What is the TAX IMPACT of SELLING property?

If property sells for more than the **adjusted basis**, the profit becomes taxable at the state and federal levels. For example, Sarah is considering selling her land because she just received a diagnosis of terminal cancer. The physician told her she may have up to three months to live. Sarah thinks selling her land would “make things easier” for her son after her death.

Sarah bought the land in 1977 for \$47,500. An Accredited Rural Appraiser placed the **fair market value** on her land at \$1.5 million. The U.S. Treasury Regulations define **fair market value (FMV)** as:

*“...the price property would sell for on the open market. FMV is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act, and both having reasonable knowledge of the relevant facts.”*

Table 1: Tax impact if Sarah sells her land

Type of Tax	Tax Rate	Calculation	Tax Owed
Federal income tax on long-term capital gain*	20%	\$1,452,500 x 0.20 =	\$290,500
Federal Net Investment Income Tax (NIIT) Depends on the size of the capital gain**	3.8%	\$1,452,500 x 0.038 =	\$55,195
Montana Income Tax on the capital gain***	4.9%	\$1,452,500 x 0.049 =	\$71,173

**Total federal and state taxes**

**\$416,868**

\*For more information about the **federal** income tax rate, go to: <https://www.irs.gov/taxtopics/tc409>

\*\*Because Sarah’s income from the sale is above \$250,000, Section 1411 of the Internal Revenue Code imposes the **Federal Net Investment Income Tax (NIIT)** at a rate of 3.8 percent on the capital gain of individuals who have income above threshold amounts depending upon their filing status, such as “married filing jointly,” “head of the household,” or “unmarried.” To view the threshold table, go to: <https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax>

\*\*\*The **Montana income tax** on Sarah's capital gain is at a rate of about 4.9 percent (estimated based on Montana tax law as of January 1, 2021).

Sarah's CPA calculated she would owe an estimated \$416,868 for the three **state and federal income taxes** if she sold her land. Sarah would "lose" \$416,868 of her capital gain of \$1,452,500 to state and federal income and NIIIT taxes. With a selling price of \$1.5 million, an estimated \$1,083,132 cash inheritance would remain for her son.

Because of the physician's prognosis that Sarah had only three months to live, her CPA and attorney made this recommendation,

*"If you want to save taxes, do **NOT** sell your land or give it away before you die. Let your son sell the land after he inherits it."*

Why? Because **stepped-up basis** applies to property upon death of the owner and **carry-over basis** applies to property given to a recipient.

## What is the meaning of STEPPED-UP BASIS?

In most cases, property such as real property, business interests, or personal property (stocks, bonds, mutual funds) transferred at death to others receive a **stepped-up basis** to **fair market value** on the date of death of the owner.

If Sarah leaves real property (home, land) or personal property (stocks, bonds, mutual funds) to her son as an inheritance, there is a new basis called **stepped-up basis** on each asset equal to the **fair market value** (FMV) of the property at the time of her death. The result is the transfer of land as an inheritance does not result in the tax liability that would be created by selling the land and then leaving cash as an inheritance for her son.

Personal representatives (PRs) of estates should seek the advice of a tax professional about conducting an appraisal of the property. PRs will want to select professionals who are experts about the property they are to appraise, whether the asset is land, a home, machinery such as used combines, tractors, and other vehicles, or stamp and coin collections, works of art, and antiques.

Finding the FMV of publicly-traded securities is much simpler than determining the FMV of real property or businesses. The FMV is the average of the highest and lowest quoted selling price of the stocks, bonds, or mutual funds on the date of death or on the alternative valuation date six months later.

## What is the TAX IMPACT if an heir sells the inherited property?

Let us revisit Sarah's situation. Assume instead of selling the property before her death, Sarah follows the advice of her attorney and CPA. She leaves the land to her son in a written will or a revocable living trust.

After Sarah's death an independent rural appraiser assessed the fair market value of the land at \$1.5 million on the date of Sarah's death. The land appraisal of \$1.5 million becomes the **stepped-up basis** on the property. Assume Sarah's son, Junior, sold the land for the appraised \$1.5 million after he inherited it.

Junior has no capital gain on the sale because he sold the land at the \$1.5 million **stepped-up basis**.

In this example, the increase in value of Sarah's land from \$47,500 to \$1.5 million would result in a taxable capital gain only if she sold the land. However, because Sarah left the land as an inheritance for her son, the land received a **stepped-up basis** from the initial purchase price of \$47,500 to \$1.5 million, the **fair market value** of the land at Sarah's death. Because Junior sold the inherited property for \$1.5 million, there is no state or federal capital gain taxation on the sale. No state or federal income taxes would be due.

Sarah's estate also does not owe a **federal estate tax** because the land's fair market value at the time of her death is below the present federal estate tax exemption of \$12.06 million (2022) for a single person and \$24.12 million for a married couple (2022). Likewise, there is no state **inheritance tax** liability on Junior's inheritance of the property because the Montana legislature ended this tax in 2001.

## Does the way an heir receives property as an inheritance affect STEPPED-UP BASIS?

No. When property passes from an owner to heirs as an inheritance by any of the methods below, the property will receive a **stepped-up basis**:

- to heirs based on Montana intestacy statutes when the owner died without a will. For more information visit, MSU Extension MontGuide "Dying Without a Will in Montana." <http://store.msuextension.org/publications/FamilyFinancialManagement/MT198908HR.pdf>
- to devisees (beneficiaries) named in a written will. For more information visit MSU Extension MontGuide "Wills." <https://store.msuextension.org/publications/FamilyFinancialManagement/MT198906HR.pdf>
- to beneficiaries by a distribution from a revocable living trust formed by the deceased. For more information, visit MSU Extension MontGuide "Revocable Living Trusts." <http://store.msuextension.org/publications/FamilyFinancialManagement/MT199612HR.pdf>
- to designated beneficiaries listed on a Transfer on Death Deed (TODD) on real property. For more information, visit MSU Extension MontGuide "Transfer on Death Deed." [https://store.msuextension.org/Products/Transfer-on-Death-Deeds-in-Montana-MT202010HR\\_\\_MT202010HR.aspx](https://store.msuextension.org/Products/Transfer-on-Death-Deeds-in-Montana-MT202010HR__MT202010HR.aspx)
- to beneficiaries listed on a Transfer on Death Registration for stocks, bonds, and mutual funds. For more information, visit MSU Extension MontGuide "Non probate Transfers." <http://store.msuextension.org/publications/FamilyFinancialManagement/MT199509HR.pdf>

In summary, after the death of the owner, all heirs receive a **stepped-up basis** on any real and personal property they inherited regardless of the "at death" transfer method used by the owner.

## What is the TAX IMPACT if an heir sells the property for more than the property's STEPPED-UP BASIS?

If heirs sell personal or real property for a price greater than the **stepped-up basis**, they have a tax liability at the federal and state levels for the difference between the **stepped-up basis** and the **selling price**. The difference is the **capital gain** on the sale. For example, if Junior sells the land he inherited from Sarah for \$2 million, there would be a \$500,000 capital gain on the sale. As a result of the sale, he would owe \$143,500 of additional federal and state taxes (20% federal income tax + 3.8% NIIT + 4.9% state income tax).

## What is the basis of property when GIFTED by the owner?

Property transferred by an owner (donor) as a gift to a donee (term for a person who receives a gift) while the donor is living receives a **carry-over basis**. The donor's **adjusted basis** in the property **carries over** to the donee.

If the donee sells the gifted property, the donee owes an income tax on the capital gains at the state and federal levels on the appreciation of the property's value. And, if there is any post-gift appreciation in the property's value during the time the donee holds the property before its sale, the donee has a tax liability for that appreciation as well.

## What is the TAX IMPACT of GIFTING property while living?

Let us revisit Sarah's situation. She bought land in 1977 for \$47,500. Assume she does not sell the land, but decides to **give** the property to her son, Junior, while she is living. At the time she made the **gift**, a rural appraiser said the fair market value of Sarah's land was \$1.5 million.

Because the land is a **gift** from Sarah to her son, the land has a **carry-over basis**. The **carry-over basis** for the land given to Junior is the **adjusted basis** Sarah had in the property at the time of her gift of the land. Sarah's adjusted basis of \$47,500 on the land carries over to Junior.

Later, Junior sold the land for the fair market value of \$1.5 million. The CPA calculated a capital gain of \$1,452,500 (\$1,500,000 sale price - \$47,500 **carry-over basis**). The CPA also informed Junior he would owe state and federal taxes of approximately \$416,868 on the capital gain from selling the gifted land. See **Table 2**.

If this table seems familiar, it is!

**By selling the gifted land, Junior would owe the same state and federal income taxes as Sarah would have had to pay if she had sold her land while she was living.**

Now you understand why the CPA and attorney told Sarah *"If you want to save taxes, DO NOT SELL OR GIVE your land away before you die."*

Table 2: Tax impact of Junior selling land given to him by his mother

Type of Tax	Tax Rate	Calculation	Tax Owed
Federal income tax on long-term capital gain*	20%	\$1,452,500 x 0.20 =	\$290,500
Federal Net Investment Income Tax (NIIT) Depends on the size of the capital gain**	3.8%	\$1,452,500 x 0.038=	\$55,195
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<b>Total federal and state taxes</b>			<b>\$416,868</b>

*If Sarah had left the land to Junior as an INHERITANCE instead of giving it while alive, no state or federal taxes would have been due. Sarah would have saved an estimated \$416,868 of taxes.*

Sarah, as the donor of the gift to Junior, would have the responsibility of filing a federal gift tax return (IRS Form 709) showing a gift valued at \$1.5 million (the fair market/appraised value on the date of gift). No gift tax would be due at that time because the amount was under the federal gift tax exclusion.

## Summary

Deciding whether to sell property before dying, to gift property while alive, or to leave an inheritance upon death is an important decision for property owners. An understanding of the meaning of **basis** and **adjusted basis** of the owner's property is vital. And, knowing the difference in value between **stepped-up basis** on inherited property and **carry-over basis** for gifted property is also important.

The owner's decision can have a profound impact on the total amount of state and federal income taxes owed. The least tax - often dramatically less - almost always results from a transfer of property at death (based on current tax law) with a **stepped-up basis**, resulting in more money for heirs. See **Table 3**. If the deceased's left cash as an inheritance, the stepped-up basis does not apply.

There may be reasons for giving assets away while alive that negate the goal of saving money on taxes. Parents may wish to give land to a child to make them part of the business operation or to encourage their remaining on the farm/ranch or join the family business. Grandparents may make gifts because they feel good about helping grandchildren financially and they are alive to see how their grandchildren benefited from the gifts.

Table 3: A TAX IMPACT summary comparison of an owner selling property, gifting it, or leaving it to an heir who sells it at the FMV

Selling property	TOTAL TAXES OWED
Sarah sells her land valued at \$1.5 million while alive <ul style="list-style-type: none"> <li>• Basis of \$47,500</li> <li>• \$1.5 million sales proceeds</li> <li>• Capital gain \$1,452,500</li> </ul>	\$416,868
Junior sells Sarah's land for \$1.5 million after inheriting it <ul style="list-style-type: none"> <li>• <b>Step-Up in Basis</b> to \$1.5 million at Sarah's Death</li> <li>• \$1.5 million sales proceeds</li> <li>• Capital gain 0</li> </ul>	\$0
Junior sells the land after Sarah's lifetime gift <ul style="list-style-type: none"> <li>• <b>Carry-Over Basis</b> of \$47,500</li> <li>• 1.5 million sales proceeds</li> <li>• Capital gain \$1,452,500</li> </ul>	\$416,868

Before you make any type of large gift, sell property, or decide to leave property as an inheritance to a designated beneficiary, contact an attorney and a CPA to assess the potential legal consequences and tax liability for your specific situation.

### References

- Internal Revenue Service: Topic No. 703 Basis of Assets. March 12, 2021 <https://www.irs.gov/taxtopics/tc703#:~:text=Basis%20is%20generally%20the%20amount,is%20its%20cost%20to%20you>.
- Internal Revenue Service: Publication 559, Survivors, Executors and Administrators <https://www.irs.gov/pub/irs-pdf/p559.pdf>
- Internal Revenue Service: Publication 544, Sales and Other Disposition of Assets, <https://www.irs.gov/publications/p544>
- Internal Revenue Service: Find out if Net Investment Income Tax applies to You, April 21, 2021. <https://www.irs.gov/individuals/net-investment-income-tax>
- Estate and Gift Tax, March 16, 2021 <https://www.irs.gov/businesses/small-businesses-self-employed/estate-and-gift-taxes>

### Acknowledgement

Representatives of the following reviewed this MontGuide. They recommend its reading by individuals interested in learning about basis in property.

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