

Key Elements of the U.S. Tax System

What is the difference between carryover basis and a step-up in basis?

WEALTH TRANSFER TAXES

Q. What is the difference between carryover basis and a step-up in basis?

A. The difference is whether heirs who sell an inherited asset will pay tax on the capital gains from the time the asset was originally purchased or from the time it was inherited. In some cases, the difference is a lot of tax liability.

A capital gain occurs if a capital asset is sold or exchanged at a price higher than its “basis,” the original purchase price plus the cost of improvements less depreciation. When a person inherits an asset, the basis becomes the asset’s fair market value at the time of the owner’s death. This is called a “step-up in basis” because the basis of the decedent’s asset is stepped up to market value. With gifts made during the giver’s lifetime, the recipient retains the basis of the person who made the gift (“carryover basis”).

The donor’s income does not include the unrealized gain (or loss) on assets given by gift or bequest. The recipient does not owe any tax until the asset is sold, at which point any gain is taxable. The taxable gain is the amount received from the sale of the asset less the asset’s basis. For most sales, the basis is the amount the taxpayer invested in the asset, adjusted for subsequent improvements, depreciation, and certain other items. For gifts and bequests, however, special basis rules apply.

For gifts, the basis remains the same as when the asset was held by the person who made the gift (“carryover basis”), but with an adjustment for any gift tax paid. For inheritances, the basis is the fair market value of the asset at the time of the donor’s death (or six months afterward, if the executor elects the alternative valuation date). This is referred to as “step-up in basis” (or “stepped-up basis”) because the previous basis is stepped up to market value.

The effect of carryover basis on gifts is to tax the unrealized gain accrued by the donor when the recipient sells the asset. The effect of step-up in basis on inheritances is to eliminate income tax on any unrealized gain accrued by the decedent.

There have been past efforts to repeal or eliminate step-up in basis.

- The Tax Reform Act of 1976 would have imposed carryover basis on all inherited assets, but the provision was repealed before it could ever take effect.
- The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the estate tax and curtailed step-up in basis, but only for one year—2010. The act limited step-up to \$1.3

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million (plus an additional \$3 million for surviving spouses) with any additional unrealized gains carried over. (Estates could elect to retain step-up in exchange for paying an estate tax; a few estates with highly appreciated assets chose this option.)

- The Obama administration proposed repealing stepped-up basis subject to several exemptions, including a general exemption for the first \$100,000 in accrued gains (\$200,000 per couple). The US Department of the Treasury estimated that, together with raising the capital gains rate to 28 percent, this proposal would raise \$210 billion over 10 years. Ninety-nine percent of the revenue raised would come from the top 1 percent of households ranked by income.

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Further Reading

Executive Office of the President and US Treasury Department. 2015. [“The President’s Plan to Help Middle-Class and Working Families Get Ahead.”](#) Washington, DC: The White House.

Joint Committee on Taxation. 2015. [“History, Present Law, and Analysis of the Federal Wealth Transfer System.”](#) JCX-52-15. Washington, DC: Joint Committee on Taxation.

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