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Legal Insights

Important Estate Planning Tax Topics: Capital Gains

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During my estate planning consultations, there are certain tax topics that routinely come up that require some level of explanation or clarification. There is often some confusion about how certain taxes work, and whether a certain tax will apply in a particular case. In this article, I will cover what I perceive as one of the most common taxes that come up, and what to consider while establishing an estate plan. The tax to be covered: the Capital Gains Tax.

Capital Gains Tax

The capital gains tax is a tax applied to the gain in value that an assets experiences while being owned by a person. Capital gains are calculated by subtracting the cost basis of an asset (i.e. the purchase price plus capital expenditures), from either the current fair market value, in the case of unrealized capital gains, or the price at which the asset is sold, in the case of realized capital gains. We tend to focus on realized gains since those result in an actual tax obligation for an individual taxpayer. However, keeping a record of unrealized capital gains is important so there are no surprises when an asset is transferred or sold.

Realized vs. Unrealized Capital Gains

To illustrate realized versus unrealized capital gains, assume Person A bought a home on January 1, 1990, for $100,000.00 (this is the cost basis). Then assume that on January 1, 2025, the fair market value of the home is $500,000.00.

- Scenario #1: If Person A continues to own the home, then as of January 1, 2025, there is an unrealized capital gain of $400,000.00.
- Scenario #2: If Person A sells the home on January 1, 2025, for fair market value, there is a realized capital gain of $400,000.

Under Scenario #1, there is no taxable event because the capital gains are unrealized. Under Scenario #2, there is a potential tax obligation created because the capital gains became realized upon the sale of the home.

Capital Gains: An Estate Planning Consideration

In the context of estate planning, many of my clients are focused on the succession of ownership of their assets. Almost all our clients want their assets to be passed on to their loved ones. In most cases, it is the older generations (grandparents and parents) who wish to pass the assets they spent their lives accumulating, to the younger generations (children and grandchildren).

When it comes to assets passing from one person to another through an estate plan, there are two main ways in which the transfers are effectuated: (1) by gift, or (2) by inheritance. There are many things to consider when contemplating the method of transfer, but the impact of the capital gains tax should be at the top of the list. This is especially true for those who purchased assets, like a home, many years ago, and after years of appreciation, are walking around with significant unrealized capital gains.

Although there may be certain benefits to making gifts during your lifetime, from a capital gains perspective, it is almost always more advantageous to transfer assets as an inheritance. And the reason is, the "step-up" in basis. With a gift, the recipient, or donee, keeps the donor's basis. With an inheritance, the donee gets a step-up in basis, which is the fair market value on the date of the donor's death. The step-up in basis is provided for under 26 U.S. Code §1014, and to put it another way, the step-up in basis is a way to eliminate existing unrealized capital gains when a transfer is effectuated.

Using the same assumptions in the example above, consider the following scenarios:

- Scenario #1: If Person A gifts the home to Person B on January 1, 2025, then Person B's basis in the home remains $100,000.00.
- Scenario #2: If Person A passes away on January 1, 2025, and Person B inherits the home, then Person B's basis in the home is $500,000.00.

You can see that there is quite a difference in the capital gains impact between the scenarios. In Scenario #1, because Person B gets the same basis as Person A, Person B has an unrealized capital gain of $400,000.00 as soon as the home is received. In Scenario #2, Person B gets the home free of any unrealized capital gains because of the step-up in basis. To take this example a step further, if Person B sells the home for $500,000.00 immediately after receiving it, under Scenario #1, Person B would have a realized capital gain $400,000.00, and under Scenario #2, Person B would have no capital gain.

Now that we know it is best, at least from a capital gains perspective, to inherit property that has appreciated, it is helpful to understand some of the ways in which assets can be transferred that qualify for the step-up in basis under §1014. Generally, any transfer that is triggered as a result of the owner's death is considered an inheritance. An asset received by the beneficiary of a decedent's probate estate or certain types of trusts is classified as an inheritance. There are also certain types of real property deeds, like a life estate deed, for example, that can transfer real property as an inheritance for §1014 purposes.

Keep in mind, real property is not the only asset class to which the capital gains tax is applied. Any asset that experiences appreciation is subject to the capital gains tax. The capital gains tax can apply to stocks and securities, cryptocurrencies, artwork, and precious metals, just to name a few.

Although inheriting is generally more favourable from a capital gains perspective, there may be other considerations that make gifting an asset the right choice in a particular case. If you are interested in better understanding estate planning options that address your concerns and achieve your goals, which may include minimizing or eliminating capital gains taxes for your heirs, you should consult with an experienced Estate Planning Attorney.

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