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Leaving assets to your heirs: Could you benefit from a step up in basis?

Consider the full picture when deciding whether to hold on to your taxable investments.

T. Rowe Price Insights on Retirement

Key Insights

- If you have assets spread across various types of accounts, it's important to develop a tax-efficient strategy.
- Utilizing the step up in basis can be a valuable strategy, as it effectively makes gains during your lifetime tax-free for your heirs.
- Four factors can help you determine whether it makes sense to hold on to taxable investments for the step up.

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Does it make more sense to pull money out of your Roth IRA or your brokerage account for income in retirement? Depending on your situation, you may want to hold on to your taxable investments for the potential future step up in basis.

If you have a brokerage account, you're probably familiar with the concept of cost basis (the original price you paid for an investment). But when you pass away, an investment's cost basis changes—it, instead, assumes the investment's value at the date of your death. This is known as a "step up in basis," and it effectively makes gains during the original owner's lifetime tax-free for his or her heirs.[1]

For example, suppose you bought a stock for $20 per share, and now it's worth $100 per share. If you sell it, you will have a taxable capital gain of $80 per share. However, if it's worth $100 at the date of your death, your heirs will only be taxed on any appreciation above $100 when they sell it. This applies exclusively to investments in taxable accounts, as opposed to tax-advantaged accounts like IRAs, Roth IRAs, and 401(k) plans.

This tax rule can be a major benefit for families with wealth beyond what they will need for personal spending in retirement. The challenge for an investor (or financial professional) is deciding whether to hold specific investments in anticipation of a step up. If you also have assets in Roth or tax-deferred accounts, you will want to develop a strategy to determine which accounts to spend down and which to preserve.

Let's take the case where you're deciding whether to fund your retirement spending with qualified tax-free Roth account distributions[2] or by selling stock (or stock fund) investments in a taxable account. For now, we'll assume your investments are similar in the two accounts. (We're aware that this is a big assumption.) There are four major factors to consider, presented in Figure 1.

Hopefully, the first three factors listed don't need much additional explanation: If you have a big, unrealized gain in your taxable investment, as well as a high tax rate, and you don't expect to live long, holding on to that investment can benefit your heirs significantly. The dividend factor, however, isn't as intuitive. Dividends matter because they are taxed every year. Compared with a stock with no dividend, a dividend-paying stock (with the same total return) incurs taxes sooner and its value grows more slowly. The impact of this tax drag

builds over the years, so it's particularly meaningful for someone with a long life expectancy. Interestingly, if the stock pays no dividend, life expectancy doesn't matter because there's no annual tax drag.

That's a lot to consider, and these factors may not align the same way in your situation. Fortunately, we can use break-even cost basis percentage graphs to help with this decision.

Break-even cost basis percentage

Consider three examples in reference to the following charts. First, calculate your taxable investment cost basis percentage. To do that, divide the cost basis—usually available on your account statement—by the current value. Then, check it against the chart on page 3. If your cost basis percentage is above the lines, it's better to sell the taxable investment than to liquidate assets in a Roth account.

Example 1: Suppose you have a stock investment worth $10,000 with a $9,000 cost basis (90% of the value). And we'll assume you will face capital gains taxes (at least 15%) on any gains you realize in your lifetime. Looking at the first graph (see page 3), 90% is above the break-even lines for both the 15% and the 20% capital gains tax rates. That means, if you need money for expenses, you should sell that taxable investment and hold on to any Roth accounts. That works out better long term (after taxes) for your heirs.

Example 2: Now suppose the investment has a $4,000 cost basis (40%) and pays a 2% annual dividend. If you're 55 and think you'll live another 30 years, that 40% cost basis is above the lines on the second graph on page 3. So you'd still want to sell the investment instead of taking a Roth distribution. Note that the break-even lines for a dividend rate below 2% would be higher on the graph—closer to the straight line in the "no dividend" graph on page 3.

Fig. 1: When is the step up most beneficial?

Factor	Situation that favors holding the taxable investment for the step up
Investment cost basis (as percentage of value)	Low cost basis (i.e., a large potential gain)
Your tax rate on capital gains	High capital gains tax rate
Your life expectancy	Short life expectancy
Investment's dividend rate	Low dividend

Example 3: But if you're 85 and figure your life expectancy is under 10 years, that moves your 40% cost basis to the right and below the lines on the second graph. That means, it makes sense to hold on to the investment for the step up and use your Roth account to fund your expenses instead.

As you put this into practice, consider a few additional details when determining whether to sell appreciated assets over Roth account investments:

- A fair number of people don't always face capital gains taxes, due to their income levels.[3] This might be applicable in some years (e.g., before required minimum distributions) but not others. To the extent you can reap untaxed capital gains, don't worry about preserving those assets for the step up.

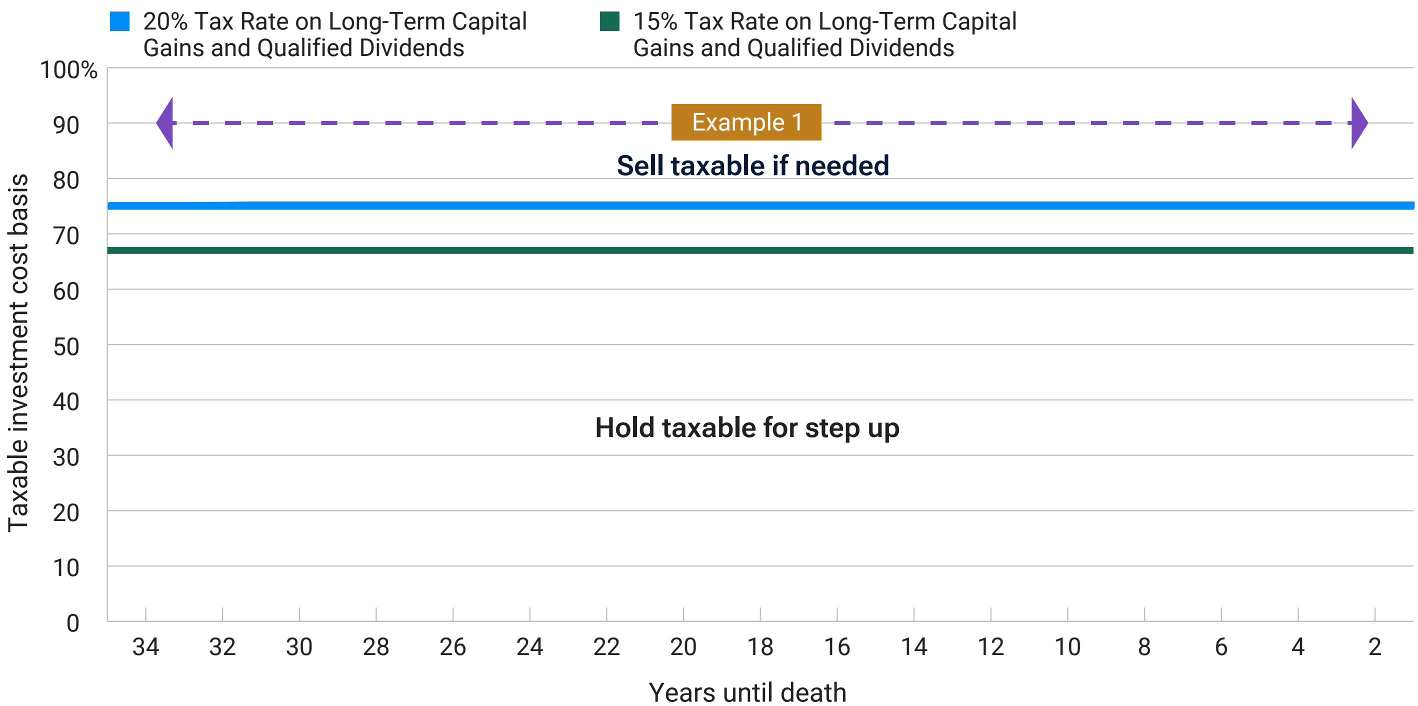
- Your investments probably aren't exactly the same in your taxable and Roth accounts. If the appreciated investment has lower growth potential than your Roth holdings, you may be more inclined to sell the appreciated investment.

- The graphs on page 3 assume that your heirs will continue to benefit from tax-free growth if they inherit your Roth account. If you think they're more likely to cash it out quickly, then it's relatively more attractive to leave them stepped-up taxable investments.[4]

- In recent years, there have been policy proposals limiting the step up in basis and increasing capital gains tax rates for some taxpayers. Those changes could significantly affect decisions about which accounts to use in retirement and which accounts to preserve. Until legislation is passed and details become clearer, we do not recommend taking dramatic steps in anticipation of potential changes.

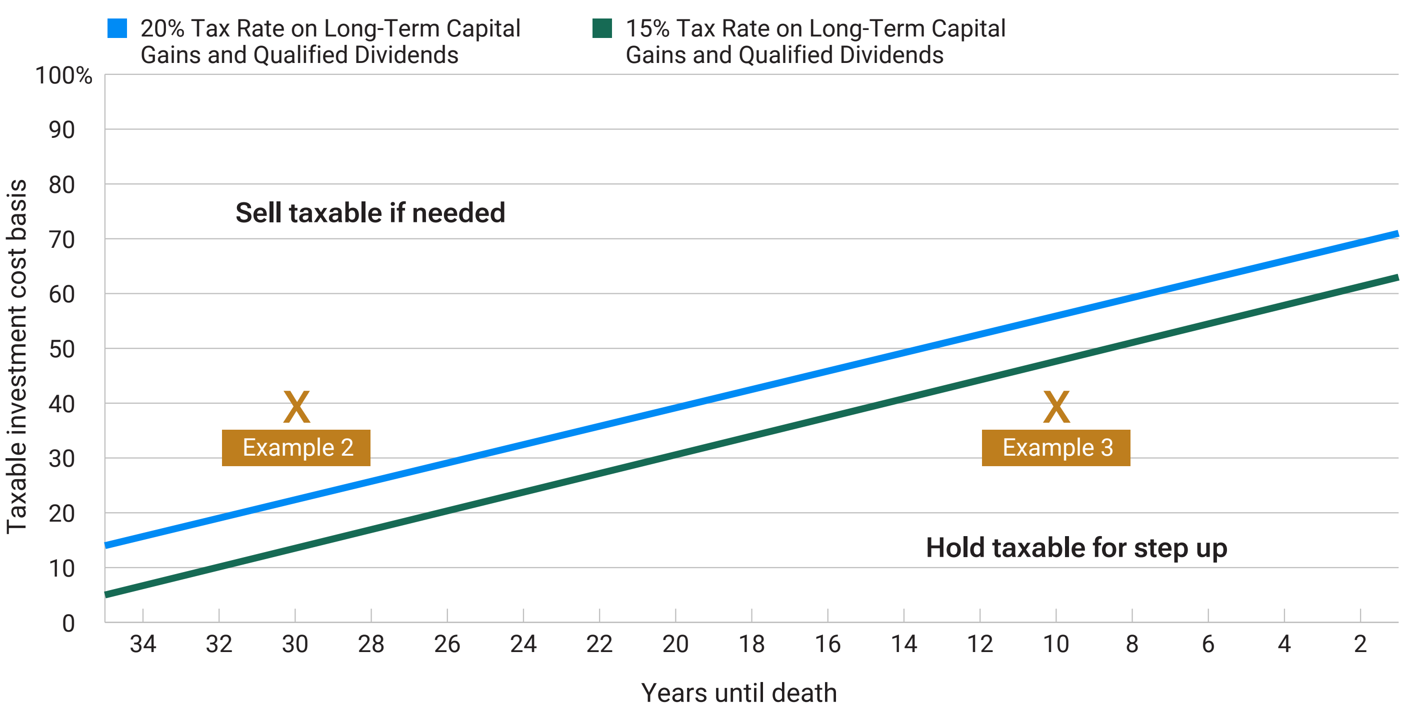
Having assets you can leave your loved ones is a good problem to have. Proper planning can help ensure that those assets are as tax-efficient as possible.

Fig. 2: Break-even cost basis percentage: Stock investment with no dividend



Source: T. Rowe Price calculations. Assumptions: All investment returns come from appreciation (long term) and qualified dividends, not ordinary income. Dividends are not reinvested. Cost basis is as a percentage of the investment value. After-tax value of a taxable asset to an heir is assumed to be 5% less than an equivalent Roth asset due to the ongoing tax benefit of the Roth account. Calculations based on formulas in "Toward Constructing Tax Efficient Withdrawal Strategies for Retirees with Traditional 401(k)/IRAs, Roth 401(k)/IRAs, and Taxable Accounts." by James DiLellio and Dan Ostrov (2020). Financial Services Review 28 (2): 67–95.

Fig. 3: Break-even cost basis percentage: Stock investment with 2% dividend



Source: T. Rowe Price calculations.

[1] Exceptions may apply.
[2] Generally, Roth IRA distributions are qualified if the owner is over age 59½ and the account has been open at least 5 years.
[3] Long-term capital gains/qualified dividends rate for 2024: A 0% rate applies to taxpayers with taxable income not over $47,025 (single filers) and $94,055 (joint filers). A 15% rate applies to taxpayers with taxable income not over $518,900 (single filers) and $583,750 (joint filers). A 20% rate applies to taxpayers with taxable income above those levels.
[4] The SECURE Act, passed in late 2019, generally requires most non-spouse IRA beneficiaries to withdraw the full account balance within 10 years.

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