The tax basis associated with an asset is the measure of your investment’s change in value between acquisition and time of sale. By subtracting the tax basis from the sales price, you determine whether you have a capital gain or loss on the asset’s sale or other disposition. It may sound straightforward, but often it isn’t. What if you received the asset by gift or inheritance—or you plan to gift the asset? What if you could apply knowledge of how a step-up in basis works so as to lower your taxes or those of the beneficiary of your gift? Understanding the role of basis may provide you with opportunities for tax savings.

Tax Basis Considerations
Taking into account the tax basis of your assets is an important part of good financial planning. It lets you better position your assets, potentially, for what could be more efficient management of your wealth. Since tax basis determines the amount of your capital gain or loss, it’s easy to see how the basis may impact your selling decisions, including timing of a sale or whether you choose to sell a specific asset at all. Suppose you desired to give an asset to a family member or charity and had two assets to choose from. Obviously, knowing each asset’s tax basis—and thus the tax consequences—could affect your decision as to which asset you would want to gift and which one you’d rather keep in your estate.

The following information will provide you with an overview of some
method commonly used to determine the tax basis of assets. Importantly, it will also show you how you can identify appropriate assets for various wealth transfer and disposition strategies, all through the lens of tax efficiency. The goal of this publication is to provide you with education and information regarding potential strategies that may be beneficial to you. Every tax situation is unique and clients should consult with their legal and tax advisors before proceeding with any potential strategy to determine how it will impact them specifically as Morgan Stanley and its Financial Advisors do not give tax or legal advice.

Determining Tax Basis
As previously stated, in general, your original tax basis is your cost, or what you paid for an asset. However, the original basis may eventually give way to an “adjusted basis.” The specifics are determined by what kind of asset you hold and what happens after acquisition — including improvements you make during ownership and even the structure of the sale when you choose to dispose of the asset.

The determination of tax basis at acquisition is fairly simple if you purchased the asset; it is generally its cost or purchase price. The rules change, though, if you are gifting the asset or are leaving it as part of an inheritance, which is discussed later. During your ownership of the asset, the tax basis may be adjusted for events such as improvements, depreciation or dividends. This results in the aforementioned adjusted basis. When selling the asset, if 100% is not sold, you may need to select a method for determining the tax basis of the shares sold. There are three methods commonly used for determining the basis on shares that are sold: specific identification, first in first out (FIFO) and average cost. If you do not select a method or cannot adequately identify the specific shares that are sold, the IRS defaults to FIFO.

**PLANNING POINT:**
The FIFO method may not provide you with the optimal result when selling shares. If the shares you have held the longest have declined in value, then the FIFO method may result in the largest capital loss; if those same shares have appreciated, the FIFO method may result in the largest capital gain. While tax minimization is usually a consideration, timing your capital gains and losses can be opportunistic — especially given the current tax environment with the potential for tax rates to rise in the future. To maintain the most control over your taxable situation, you may want to elect the Specific Identification method, identifying which shares are to be sold with your broker. If you choose this method, be certain to receive written confirmation.

Wealth Transfer Strategies

**Lifetime Gifts**
Gifting during one's lifetime is a common wealth transfer strategy clients opt for so that they can experience the joys of giving while they are alive. On the practical side, it also reduces the size of a donor's taxable estate. You can use this planning strategy by gifting to benefit your favored philanthropic causes as well as for gifting to loved ones.

The tax basis and holding period of an asset gifted during life is generally the same as that of the donor, referred to as carryover basis and holding period. Therefore, when gifting to charities, you generally want to utilize lower basis assets, because if you were to sell the asset yourself you would have to recognize a large capital gain. By gifting the long-term highly appreciated value asset to charity, you not only potentially get an income tax charitable deduction but you also potentially prevent the tax on the capital gain.

The opposite is true when gifting to family and friends. You generally want to gift higher basis assets — assets of lesser-appreciated value — so that when the beneficiary is ready to sell the asset, he or she will recognize a potentially lower tax on the capital gain. The gain or loss will be classified as long-term or short-term gain depending on the length of time you held the asset, as your holding period also carries over to the beneficiary. Note that if you paid any gift taxes on the transfer, the beneficiary's basis is generally increased by a portion of the gift taxes you paid.

**PLANNING POINT:**
In general, when gifting assets to loved ones, consider gifting from your higher basis, long-term assets so as to transfer the lowest long-term built-in gain. When the recipients choose to sell the assets, they too will have a higher basis and therefore will potentially have lower long-term capital gains.

**Exception**
A special exception to the carryover basis rule applies if, on the date of the gift, the fair market value of the asset is less than the basis. When the beneficiary goes to sell the asset, their basis for determining a gain is the same as the donor’s basis (carryover) and their basis for determining a loss is the fair market value. If using the basis for determining a gain results in a loss and using the fair market value basis for determining a loss results in a gain, the beneficiary will end up with neither a gain nor a loss. See the example on the right.


**Planning Point:**

If the fair market value of the asset you want to gift is less than your adjusted basis on the asset, consider selling the asset as a first step. You may be able to recognize the capital loss and then gift the cash proceeds. Note that you would be unable to transfer a loss.

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**Two-Year Gifting Opportunity**

Recent tax legislation included in the 2010 Tax Relief Act creates a unique two-year (tax year 2011 and 2012) window of opportunity for very wealthy clients to utilize their lifetime gift tax exemption, which is currently $5 million. Unless additional legislation is passed, the gift tax exemption is set to revert to $1 million in 2013.

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**On Gift Date, Fair Market Value is Less Than Donor’s Basis**

| Date of Gift Adjusted Basis | $10,000 |
| Date of Gift Fair Market Value | $9,000 |
| Sales Price | $9,500 |

<table>
<thead>
<tr>
<th>In Determining a Gain</th>
<th>In Determining a Loss</th>
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<tbody>
<tr>
<td>Sales Price</td>
<td>$9,500</td>
</tr>
<tr>
<td>Use Donor’s Adjusted Basis</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Results in Loss</td>
<td>($500)</td>
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</tbody>
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Therefore, No Gain or Loss

For Illustrative Purposes Only—Consult Your Tax Advisor

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**Planning Point:**

Previously, clients were only able to pass $1 million of their estate tax exemption (currently $5 million in 2011 and 2012) during life without incurring a gift tax. Now, there is a short window of opportunity to give an additional $4 million while living. By gifting assets now, any future appreciation from the gifting date forward will be passed on to your beneficiaries and may not be subject to further gift or estate tax. If you do not choose to make the gift now, the amount of the gift later — and the subsequent appreciation — could be subject to taxation.

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**Gifts Made at Death**

Treated the opposite of lifetime gifts, a beneficiary’s tax basis on an inherited asset is the fair market value on the date of a decedent’s death, or on the later alternate valuation date if selected instead. The alternate valuation date is the value of the gross estate that may be determined, if the executor elects and the estate qualifies, by valuing all of the property as of the date six months after the decedent’s death. This is referred to as the asset receiving a step-up in basis to the fair market value.

By holding a low-basis asset until death, there would be a step-up to fair market value and the owner would have relieved himself or herself of the capital gain on an eventual sale. Therefore, any low-basis assets that you own could be great assets to target for charity by bequest because charities are typically tax-exempt entities (confirm the tax-exempt status of any charity before giving, and consult your tax advisor); they would not have to recognize the capital gain on the sale of your asset at death. Additionally, IRAs and other retirement plan assets have never been taxed and never get a step-up in basis. Leaving these assets to charity at death provides for a potential estate
tax charitable deduction as well as possibly preventing income tax that your loved ones would have had to pay on IRA distributions.

<table>
<thead>
<tr>
<th>Pass</th>
<th>During Lifetime</th>
<th>At Death</th>
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<tr>
<td>To Charity</td>
<td>Low Tax-Basis Assets</td>
<td>Low Tax-Basis Assets</td>
</tr>
<tr>
<td>To Heirs</td>
<td>High Tax-Basis Assets</td>
<td>Low Tax-Basis Assets</td>
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When gifting to family members, low-basis assets are best because the assets will receive a step-up in basis to fair market value at death, and you will have relieved your estate as well as any beneficiary of the capital gains. Additionally, a Roth IRA would be a better asset to leave by bequest because Roth IRA distributions are not subject to income tax, as is the case for traditional IRAs.

**PLANNING POINT:**

Depending on the composition of your assets, it may make sense to leave lower tax-basis assets in your estate so that upon your death, your beneficiaries receive a step-up in basis on those assets, lessening a potential gain upon a future sale by your beneficiaries.

**Appreciated Property**

As stated previously, the basis of property passed via inheritance is generally the fair market value on the date of death or the alternate valuation date. This rule does not apply to appreciated property that you pass to a beneficiary if that beneficiary originally gave you the property within one year of death.

The beneficiary’s basis would be the same as your adjusted basis in the property immediately before death, as opposed to the fair market value.

**PLANNING POINT:**

In a situation with one spouse near death, spouses often mistakenly believe that they can benefit from a transfer of assets from the healthy spouse to the near death spouse so that upon death the assets will get a step-up in basis when they pass back to the healthy spouse. This plan won’t work unless the transferee survives at least one year beyond the transfer date. The IRS “looks back” to see when the property was transferred.

**Sales**

The general rule to determine your capital gain or loss is to compare the amount you realize from the sale to your adjusted tax basis. Your realized amount is generally everything you receive less expenses of the sale such as redemption fees, sales commissions and charges.

Sometimes it is more beneficial to recognize a capital gain in the present, as opposed to deferring the gain into the future at a potentially higher capital gains tax rate. The federal capital gains tax rate is currently 15% for 2011 and 2012. However, for those taxpayers whose taxable income (including the capital gain) puts them in the lowest two tax brackets (10% or 15%), the capital gains are currently taxed at 0%. If there is no further legislation before 2013, capital gains rates revert to 20% for high income earners and 10% for the lowest two tax brackets. There is currently a 2% rate reduction for property held more than five years.

**PLANNING POINT:**

If you’ve already decided to sell an asset, consider taking advantage of the 33% tax savings by utilizing the 15% capital gains rate today as opposed to subjecting your gain, potentially, to 20% in 2013.

**PLANNING POINT:**

Finally, from a timing perspective, it may be more efficient to recognize capital gains now at lower rates and save loss positions to offset income taxed at higher rates that are projected to come in the future. For example, long-term losses used against short-term gains are more tax efficient than short-term losses used against long-term capital gains.

No matter if your strategy is to gift during your life, to pass your assets on through bequests or to sell over time, the tax basis of those assets can play an important role in possibly selecting the most appropriate asset for each strategy to achieve tax efficiency. Prior to implementing any of these strategies, consult with your legal and/or tax advisors.

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Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley does not render advice on tax and tax accounting matters to clients. This material was not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax laws. Morgan Stanley and its Financial Advisors do not provide tax or legal advice. Individuals should consult their personal tax advisor or attorney for matters involving taxation and tax planning and their attorney for matters involving personal trusts and estate planning.

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