Tax Basis: What Is It? Why Is It Important?

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Summary

"Tax basis" is one factor used to determine the income tax consequences when an item is disposed of, whether by sale, abandonment, or contribution. The initial basis is usually cost; however, the basis of a gift is related to its basis in the donor's hands, and the basis of inherited property is generally the property's fair market value on the date of death. The taxpayer's use of the item and subsequent events may require adjusting the original basis, which leads to the term "adjusted basis." Adjustments may either increase or decrease the taxpayer's basis in the property.

On July 30, 2008, Congress passed the Housing Assistance Tax Act of 2008 as part of the Housing and Economic Recovery Act of 2008 (P.L. 110-289). It includes a refundable credit for first-time homebuyers. Unlike other proposals for homebuyer tax credits considered by the 110th Congress (H.R. 5565; S. 12, S. 2566, S. 2734), taxpayers generally are not required to reduce their basis in their newly acquired property by the amount of the credit, but are required to pay the credit back. There is a provision for reducing the basis by the credit if the taxpayer sells the property before repaying the credit. In this case, the reduced basis is used to determine whether the taxpayer must repay the remaining credit.

Other recently passed legislation requires reduction in the basis of a taxpayer's principal residence if the taxpayer has cancelled mortgage debt that is excluded from gross income (P.L. 110-142). The Internal Revenue Code (I.R.C.) has a number of provisions that require taxpayers to reduce their basis in property and others that allow them to increase their basis in property.

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Purpose and Scope

This report provides a simplified explanation of the meaning of "tax basis," the factors that determine a taxpayer's tax basis, and some of the ways in which tax basis is used. It is intended to address some situations encountered by individual taxpayers and small businesses. It does not address tax basis as it applies to corporate assets nor as it applies to shareholders' basis in stock received in exchange for property contributed to a corporation. The tax basis and sale of inventory is also outside of the scope of this report, as is the basis of property that is converted from personal use to business use.

The basis rules are found in the Internal Revenue Code (I.R.C.) §§ 1011 - 1023.[1] This report is only a general overview of a very complex topic.

What Is "Tax Basis"?

Tax basis is the amount that a taxpayer can use as the cost of property that is sold, abandoned, or given away. When property is sold, taxpayers must report gain if the amount received for the property is more than the property's tax basis. Gain must be reported even if the property was only used for personal purposes. When the tax basis is more than the property's sales price, the result is a loss. However, the loss generally cannot be used on a tax return if the property was only used for personal purposes. When property is abandoned, a taxpayer who used the property to produce income may be able to deduct the basis of the property on the tax return for the year in which the property is abandoned. When property is given as a gift to another person, the donor's basis is important because it affects the recipient's basis in the property.

How Is the Initial Basis Calculated?

There are basically three ways of acquiring property: purchase, inheritance, and gift. The basis of property depends on how it was acquired.

Purchased Property—I.R.C. § 1012

The initial basis of property that is purchased is the purchase price, including sales tax. If a rebate is received, the basis must be reduced by the amount of the rebate.

Inherited Property—I.R.C. § 1014

The initial basis of property that is inherited is what it was worth on the day that the person from whom it is inherited died. There is an exception if the estate chose the "alternative valuation date" for valuing the entire estate. In that case, the initial basis of the property would be its valuation six months after the date of death. Whichever date is chosen by the estate for valuation, generally the property is valued at its fair market value on that date. There are some special rules for family farm property, and the value of minority shares of stock in closely-held corporations may be reduced. However, the general rule is that when property is inherited, the recipient's basis in the inherited property is the fair market value of the property on the date of death. This "step-up" in

[1] The Internal Revenue Code is Title 26 of the United States Code.

basis would be eliminated for one year in 2010, but under current law, would be in effect for years after 2010. However, a number of laws were introduced in the 110th Congress that would have changed this. More information about these proposals can be found in CRS Report RL34374, *Estate Tax Legislation in the 110th Congress*, by (name redacted).

Gifts—I.R.C. § 1015

Property that is received as a gift is the most difficult category for determining initial basis. If the gift's value required gift tax to be paid, that tax may increase the recipient's basis in the gift. Several factors determine the extent to which the basis would be increased; therefore, this report will not address the effect of gift tax on the recipient's basis in the property.

Even if there is no gift tax involved, determining the recipient's basis of gifts can be complex. The basis may be the same as the donor's adjusted basis—discussed below. This is always the case when the fair market value (FMV) of the gift, at the time it is given, is greater than the donor's basis in the gift. However, in many cases, the FMV is lower than the donor's basis. This must be considered in determining whether there is a gain or loss when the recipient sells the property.

If the FMV of the gift was lower than the donor's adjusted basis at the time of the gift, the donor's adjusted basis is the starting point for determining how much gain is realized when the property is sold by the recipient. However, if the sales price is lower than the donor's adjusted basis, the FMV at the time the gift was received will be the recipient's initial basis in the property for determining the amount of loss from the sale. In some cases, there will be no gain and no loss, as discussed later.

Basis Determination Example—FMV Is Greater than the Donor's Basis. "Mom" gives "Daughter" a ring that Mom bought 10 years ago for $500; there are no adjustments to the basis, so Mom's basis in the ring was $500. The ring's current FMV is $1,200. Daughter's basis in the ring is $500.

Basis Determination Example—FMV Is Less than the Donor's Basis. "Mom" gives "Son" a desk when he goes away to college. Mom paid $400 for the desk when she bought it at a resale shop in 2000, has only used it for personal purposes, and has no adjustments to her basis in the desk. Her basis is, therefore, $400. The FMV of the desk is only $300 when Son receives it. If Son later sells the desk, his basis will depend on the sales price of the desk.

- Sale Price Less than Donor's Basis—If Son sells the desk for $250, his basis for determining loss would be $300—the FMV when Mom gave him the desk.
- Sale Price More than Donor's Basis—If Son sells the desk for $425, his basis for determining gain would be $400—Mom's basis in the desk.

How Is Basis Adjusted?

A taxpayer's basis in property may be increased or decreased after the property is acquired. The most common situation in which the basis in property is decreased is when the taxpayer uses the property for work or business and is allowed to take a deduction for tax purposes. The most common situation in which the basis in property is increased is when the owner improves the property and incurs expenses in making the improvements.

Decreases in Basis

Although decreases in basis are most common for property used for work or business, decreases may also occur in property that is only used for personal purposes.

Business-use Property

Tax deductions are often available for property that is used for work or business.[2] The basis of business-use property must be reduced by the deductions that are allowed for the property. Property that is expected to last more than a year generally must be depreciated over its useful life. This would mean that each year a portion of its cost could be deducted on the taxpayer's return. In contrast, the entire cost of property expected to last for no more than one year would be deducted in the year it was first used. Thus, this property's basis would be zero at the end of the first tax year.

Property with a useful life of more one year includes equipment, automobiles, and buildings, including rental property. For this property, the original basis of business-use property is reduced each year by the depreciation that is allowable on the tax return whether or not that depreciation was actually claimed on the tax return. If the taxpayer claimed more depreciation than was allowable, the larger amount is used to reduce basis. This means that if depreciation could have been taken, it will reduce the basis of the property even if that depreciation was never claimed on a tax return. This concept is particularly important for people who own residential property that they rent out. Even if taxpayers do not take the depreciation deduction, they will still have to reduce their basis in the property when calculating their gain on the sale of the property.

Personal-use Property

A taxpayer may need to reduce the basis in either business- or personal-use property if that property is damaged (a casualty loss) and the taxpayer receives an insurance settlement or other payment for the damage. If a car is damaged by hail and the owner receives a check from the insurance company for the damage, the basis in the car must be reduced by the amount of the check. If the car is later repaired, the basis will be increased as explained later.

In some cases, the basis in personal-use property may need to be reduced because the buyer was able to reduce her tax liability as a result of the purchase. The most common example of this involves the purchase of a principal residence. Current law allows the buyer to take a deduction on Form 1040 Schedule A for the points[3] that were paid by the seller. The basis of the residence then must be reduced by the amount of the points.[4] Tax credits for those who purchase certain financially distressed properties as their principal residence were proposed in the 110th Congress.[5] Each of the proposals would require buyers to reduce their basis in the residence by the amount of the credit.

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[2] *See* 26 U.S.C. §§ 162, 167, 179.

[3] These are generally a loan origination fee and discount points, which are both reported on the closing statement.

[4] This only applies to points paid by the seller. Points paid by the buyer do not reduce basis. *See* Rev. Proc. 94-27, 1994-1 C.B. 613 (Mar. 28, 1994).

[5] H.R. 5565; S. 12, S. 2566, S. 2734.

The Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142) allows taxpayers to exclude debt cancellation from income when part of the acquisition debt on their principal residence is cancelled or forgiven. However, taxpayers taking advantage of this provision must reduce their basis in their principal residence by the amount of the debt cancellation income that was excluded from income.[6]

The Housing Assistance Tax Act of 2008 (P.L. 110-289) provides a refundable tax credit to first-time homebuyers who purchase a principal residence after April 8, 2008, and before July 1, 2009. The credit is generally repaid over a 15-year period and the basis of the property is not reduced by the credit. However, if the property is sold before the credit is fully repaid, the taxpayer generally must repay the remaining amount in the year of the sale. An exception exists if the gain on the sale is less than the outstanding credit. To determine whether any or all of the outstanding credit must be repaid, the gain must be recalculated. For this recalculation, the adjusted basis of the property must be reduced by the outstanding credit. This reduction in basis is used only to determine repayment of the credit. It is not used to determine the gain realized for tax purposes.[7]

A less common situation in which basis in personal-use property would be reduced involves an easement. In this situation, the property owner grants someone else the perpetual right to non-exclusive use of part of the property.[8] An example would be allowing an adjacent property owner to use a driveway on the first owner's land. If payment was received in exchange for this perpetual right, the amount received for the use of the driveway would reduce the basis of the land where the driveway was located. Another situation would involve a severance award connected with an "involuntary conversion" or "condemnation." An example would be a house owned on a narrow street that the city has decided to widen. Part of the land the house is on will be used for the wider street. The land owner might be given a severance award to compensate for expenses that would be incurred to replace a fence, trees, etc. The severance award would reduce the basis on the remaining property; however, that basis would be increased to the extent that money was spent to install a new fence, etc.

Increases in Basis

The most common way in which basis in property is increased is by improvements made to the property. Improvements must be distinguished from repairs. Repairs are generally maintenance expenses. These would include painting a house, repairing a roof, sealing a driveway, cleaning airducts, changing oil in a car, and having a ring cleaned and prongs tightened. In contrast, improvements would include adding a room to your house, replacing the entire roof on a building, paving a driveway, putting a new engine in a car, and replacing a small stone in a ring with a larger one. Improvements also include restoring damaged property to the condition it was in before the casualty loss.

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[6] For more information about the Mortgage Forgiveness Debt Relief Act of 2007, please see CRS Report RL34212, *Analysis of the Tax Exclusion for Canceled Mortgage Debt Income*, by (name redacted) and (name redacted).

[7] For more information about the first-time homebuyer credit, please see CRS Report RL34664, *The First-Time Homebuyer Tax Credit*, by (name redacted).

[8] If the right was for a fixed period of time, rather than perpetual, money exchanged for the temporary easement would generally be considered rent and, therefore, includible in gross income when received. Rents received do not reduce the basis of the underlying property.

In the case of a casualty loss, such as the car with hail damage that was discussed above, basis would have been reduced by the insurance settlement, but restoring the car to its previous condition would increase the basis by the amount spent on restoration. As an example, consider a car whose adjusted basis was $11,000 before the hail damage. The insurance company determined that there was $1,500 in damage to the car. The owner's policy had a $500 deductible; therefore, the check from the insurance was only $1,000. The adjusted basis in the car is $10,000 ($11,000 - $1,000) after the owner receives the insurance check. By shopping around, the owner finds someone who will restore the car for $1,200. The basis in the car after the owner pays $1,200 for the restoration is $11,200 ($10,000 + $1,200). It does not matter that the restoration was done for less than the insurance company estimated. Similarly, if the owner found that all the reputable repair facilities cost more than the $1,500 estimated by the insurance company, the basis would be increased by the amount paid for the restoration. If the restoration cost $1,800, the owner's basis in the car would be $11,800 after restoring it. Furthermore, the cost of restoring damaged property increases the property's basis even if there had been no decrease in the basis from insurance proceeds (or other settlement).

When free labor, by the owner or by friends and family, is used to improve property, there is no increase in basis for the value of the work performed—sometimes called "sweat equity." The value of the property may increase, but the basis is unchanged unless there are out-of-pocket expenses incurred for the improvements.

How Is Basis Used in Tax Law?

Basis determines whether there is a gain or loss when property is sold. For business-use property, basis is one factor used to determine allowable depreciation.

Depreciation of Business-use Property—I.R.C. § 167

Depreciation for business-use property is based on the property's basis and its "class-life." If improvements are made to the property, those improvements are depreciated separately from the original property, but the adjusted basis of the improvements increases the adjusted basis in the property when it is sold.

Determining Gain or Loss when Property Is Sold—I.R.C. § 1001

When property is sold, the gain or loss is determined by subtracting the adjusted basis of the property from the sales price. If the difference is greater than zero, there is a taxable gain. If less than zero, there is a loss, but its deductibility for tax purposes will depend upon whether the property was used for business, investment, or personal purposes.

Gains

The taxable gain generally is the difference between the sales price and the adjusted basis, but the gain can be reduced by expenses incurred in selling the property. This is true whether the property was business-use property or only used for personal purposes.

Gain Calculation Example. A man received a stuffed animal costing $2 as a gift from his parents thirty years ago. This man has now discovered that this particular toy is considered rare and

valuable and decides to sell it on an Internet auction site. The man's adjusted basis in the toy is $2—his parents' basis when they gave it to him. The sales price is $150. The difference is $148, but he had to pay $15 to the auction site and $5 to ship the toy to the buyer. His gain on the sale is $128 ($150 - $2 - $15 - $5 = $128).

Losses

Calculating losses is done in a similar way; however, only losses generated by business- or investment-use property can reduce taxable income. Losses on personal-use property cannot be deducted. Sales expenses increase the amount of loss.

Loss Calculation Example—Business-use Property. A landscaper owns a large mower that was purchased for $2,500 in July 2005. The allowed and allowable depreciation is $1,775 for the period of ownership and use. Thus, the adjusted basis is $775 ($2,500 - $1,775 = $775). An advertisement costing $50 was placed in the local paper to sell the mower. The mower was sold for $500. The landscaper's tax return will report a $325 loss from the sale of the mower ($500 - $775 = -$275; -$275 - $50 = -$325).

Loss Calculation Example—Personal-use Property. A couple received a china gravy boat as a wedding present. The gift cost $150. They received no other china in the pattern they had chosen and have realized they will not be using the gravy boat. So they list the gravy boat on an Internet auction site. When the bidding closes, the winning bid is only $100. The fee for the auction site is $10 and it cost another $15 to ship the gravy boat to the buyer. There is a $75 loss on the sale ($100 - $150 = -$50; -$50 - ($10 + $15) = -$75). Since the gravy boat was personal-use property, the loss cannot be claimed on the couple's tax return; however, the $100 received is not included in gross income. (This is why money generated by a personal garage sale is generally not includible in income for tax purposes.)

No Gain, No Loss

Gifts, as noted earlier, are complex. In some cases, property received as a gift may be sold with no resulting gain or loss. This occurs when the sale price is more than the property's FMV at the time of the gift, but less than the donor's basis.

Example of No Gain, No Loss Sale—Sale Price Less than Donor's Basis, but More than FMV at the Time of the Gift. Refer to the earlier example where Son received a desk from Mom. The donor's basis was $400, but FMV at the time of the gift was $300. If Son sells the desk for $325, he will have no gain and no loss:

- Donor's basis is used to calculate gain—$325 - $400 = -$75, so there is no gain;
- FMV at the time of the gift is used to calculate loss—$325 - $300 = $25, so there is no loss.

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