Basis

# Introduction

The concept of basis is an extremely important one in the current tax law. It is one of only a very small number of items that carries over from one year to the next when determining tax liability. For example, basis is used in determining:

1. gain or loss on the sale of an asset,

2. depreciation or amortization expense, and

3. deductibility of certain losses.

Basis is most commonly interpreted as the amount one pays for an asset. When that asset is sold, basis is subtracted from the amount received to determine the overall gain or loss realized. In this case, basis is the portion of the gross proceeds that is recovered income tax free upon the sale of an asset.

*Example:* Mark buys a plot of land for $10,000 using funds that he saved from working in a local restaurant. The $10,000 Mark paid for the land represents his basis in the land. A few months later, John offers to purchase the land from Mark for $25,000. To compute his reportable gain, Mark may subtract his basis from the amount he realizes in the sale. So Mark’s gain would be $15,000, the $25,000 realized minus Mark’s $10,000 basis. Without the basis rules, Mark would be taxed not only on the appreciation of the land, but also on his purchase price which came from savings which were already taxed when it was earned. So basis is a means by which the tax law prevents double taxation.

Because basis carries over from one year to the next and may be adjusted every year, it is one of the more complex and cumbersome burdens for taxpayers to comply with when preparing and filing their income tax returns. It is also an area that the Internal Revenue Service is likely to challenge upon the examination of a return. Maintaining complete, meticulous, and easily retrievable records of purchase payments and capital outlays is the best means of substantiating basis.

# A Starting Point

As mentioned above, the starting point for determining basis is the amount that is paid in cash or other property for a particular asset. For example, Aaron Sterling, an investor, buys 100 shares of LISI, an information and analysis provider. Aaron’s basis for his 100 shares of LISI will be the total price he paid. This includes any fees and commissions incurred as a result of the transaction. If the per share price at the time of purchase of the 100 shares is $50 and a

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$30 commission was paid on the transaction, Aaron’s original basis is $5,030 (the total of the $5,000 cumulative share price plus the $30 commission).

When property other than (or in addition to) cash is used to acquire an asset, and the transaction does not qualify as a tax-free exchange, the basis of the property acquired is the sum of (a) any cash paid *plus* (b) the fair market value of any property transferred by the buyer. For instance, if Max Sterling purchased rental property for $10,000 in cash plus IBM stock worth $90,000, Max’s original basis in the rental property would be $100,000 (the sum of the $10,000 cash he paid plus the $90,000 fair market value of the stock he transferred to the seller).

Typically, when an investor exchanges one property for another in an arm’s length transaction, the market value of the property given up and the market value of the property received will be approximately equal. The fair market value of both properties will, as a practical matter, usually be ascertained by reference to the property whose value is most easily determined. In the example in the previous paragraph, it is easy to determine Max’s basis in the rental property since Max paid for the property with cash ($10,000) and publicly traded IBM stock ($90,000), the value of which can easily be found.

When property is acquired subject to a mortgage or other debt, the basis of the property is not merely the amount of the investor’s equity in the property. The basis is the total of the cash *and* the value of other property paid *plus* the amount of the debt assumed or incurred. For example, if Charlie Ratner buys a $1,000,000 apartment house, paying $250,000 in cash and borrowing the remaining $750,000, his basis in the property is the sum of the cash he’s paid plus the debt he has assumed, (i.e., the full $1,000,000).

Basis is also used in depreciation calculations. The owner of property used in a trade or business that is subject to depreciation will use basis to determine the annual amount of expense. In the above example, Charlie’s depreciable basis in the apartment house is $1,000,000 minus the amount of cost allocable to the land on which the building sits.

# Basis Variations

What complicates matters is the number of variations that exist for basis. Simply adding a word before “basis” changes the meaning within the tax law. What follows are examples of variations of the term “basis” and a short description of when the variation might be used.

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*Cost basis:* “Cost basis” refers to the basis of property acquired by purchase. The cost of property includes amounts paid in cash, debt obligations assumed, or other property transferred by the buyer to the seller as part of the purchase price.[[1]](#endnote-1)

*Carry-over (or” transferred”) basis:* The donee (recipient) of a gift has a cost basis even though he or she may have paid nothing (see “transferred basis” and “stepped-up” basis, below).

*Adjusted basis:* The tax impact of certain transactions that occur after the initial purchase of a property may create the need for adjustments to the basis. Positive (upward) adjustments are made—and therefore basis is increased—when the owner makes additional investments or improvements with respect to the original property.[[2]](#endnote-2) Downward adjustments are made—and therefore basis is reduced—when depreciation is claimed on property used in a trade or business.[[3]](#endnote-3)

*Unadjusted basis:* “Unadjusted basis” is the amount of basis that can be claimed as cost recovery deductions (depreciation) over the duration of the recovery period (depreciable life) of the asset.[[4]](#endnote-4) This term is used almost interchangeably with “depreciable basis” and is also used to identify a property’s original cost basis.

*Exchanged basis:* “Exchanged basis” is basis that is determined in whole or in part by reference to other property held at any time by the taxpayer.[[5]](#endnote-5) The most common application of this term is in the situation of a taxpayer who acquired property in what is called a “like-kind exchange” under Code section 1031. Prior to the enactment of Code section 7701(a)(42), “substituted basis” was used to describe what is now called “exchanged basis.” In the context of a like-kind exchange, the exchanged basis starts with the taxpayer’s adjusted basis in the relinquished property, and then (1) increases it by any gain recognized by the taxpayer in the exchange, and (2) decreases it by the value of any boot received.[[6]](#endnote-6)

*Transferred basis:* As described more completely later in this chapter, “transferred basis” is basis that is determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor of property.[[7]](#endnote-7) Prior to the enactment of Code section 7701(a)(43), this was usually referred to as “carryover basis.” Many practitioners, and even some Code sections, continue to refer to transferred basis as carryover basis.

*Stepped-up basis:* Property received as an inheritance may obtain a “stepped-up” basis. If the decedent’s property had a fair market value that exceeded its adjusted basis on the date of death, the property in the hands of the beneficiary receives a basis equal to the fair market value—that is, the basis gets a “step up” from the level it was at before

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the death occurred. For instance, if Dr. Rob Sterling purchased a home in Baltimore for $600,000 and it was worth $900,000 at the date of his death, Rob’s heirs would compute any gain on a later sale using the stepped up $900,000 basis. (It is also possible for basis to be “stepped-down). These concepts will be explained more completely later in this chapter.

*Negative basis:* As a general rule, a taxpayer’s basis is not permitted to be adjusted below zero. If negative basis were permitted, taxpayers could receive benefits for funds that were not actually spent on the asset. “Negative basis” is often used, even incorrectly, to describe situations in which a taxpayer’s investment in a partnership or S corporation is reduced by losses in excess of their initial amount of capital. The impact of basis adjustments on flow-through entities will be discussed more completely later in this chapter.

# Basis for Alternative Minimum Tax Purposes

The alternative minimum tax (AMT) is determined under a separate set of rules (See Chapter 18, Alternative Minimum Tax). Because certain items are treated differently for the purpose of computing a taxpayer’s exposure to the AMT, there are times when it is possible for a taxpayer to have two or more adjusted basis figures for the same property.[[8]](#endnote-8)

The most common difference in basis between the two tax systems is with adjusted basis for determining depreciation. Depreciation for certain property placed in service before January 1, 1999 was computed for AMT using different recovery methods and potentially longer lives. For assets placed in service after 1998, taxpayers must recompute depreciation using the same recovery period that they use for regular tax purposes but potentially a different recovery method.[[9]](#endnote-9) As a result, upon the disposition of such an asset, the gain or loss for regular tax purposes will be different than what will be reported for the AMT. This disparity is due to the difference in the adjusted basis at the time of disposition.[[10]](#endnote-10)

Corporate taxpayers that are subject to recomputing their depreciation using the allowable methods and lives for adjusted current earnings (ACE) may find that they have yet another set of adjusted basis numbers to track.[[11]](#endnote-11)

Another area in which a taxpayer may have a different adjusted basis for regular tax and AMT purposes is with incentive stock options (ISOs). Although there is an exclusion from gross income for stock acquired by the exercise of ISOs, the exclusion is not permitted for the AMT.[[12]](#endnote-12) As a result, the adjusted basis of the stock will be different.[[13]](#endnote-13)

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The concept of basis is also applied to a taxpayer’s investment in a pass-through entity, such as a partnership, limited liability company (LLC), or S corporation, to determine if losses from an entity are deductible. In a similar manner, individuals and certain C corporations must apply the at-risk limitation rules to activities that generate losses.[[14]](#endnote-14) The at-risk rules are covered in detail in Chapter 20, Passive Activity and At-Risk Rules.

Partnerships (or LLCs Taxed as Partnerships)

A partner or LLC member (hereinafter referred to as “partner”) typically determines his or her basis in their partnership interest (also known as the partner’s “outside basis”) starting with their initial investment in the partnership.[[15]](#endnote-15) The starting point may be different if the partner acquired the partnership interest in any way other than as a direct purchase or contribution upon formation.

After the original cost basis is determined, the following adjustments are made each year to the partner’s basis:

* increases for the partner’s distributive share of the partnership’s taxable income,[[16]](#endnote-16)
* increases for the partner’s distributive share of the partnership’s tax-exempt income,[[17]](#endnote-17)
* increases for the partner’s distributive share of the partnership’s excess of depletion deductions over the basis of the depletable property,[[18]](#endnote-18)
* reductions for distributions,[[19]](#endnote-19)
* reductions for the partner’s distributive share of partnership losses,[[20]](#endnote-20)
* reductions for the partner’s distributive share of partnership expenditures that are not capitalized and not deducted,[[21]](#endnote-21) and
* reductions for the partner’s depletion deduction for partnership oil and gas property to the extent it does not exceed the proportionate share of the adjusted basis of the property allocated to such partner under Code section 613A(c)(7)(D).[[22]](#endnote-22)

As previously mentioned, in no situation is a partner’s adjusted basis reduced below zero.[[23]](#endnote-23) In the event that any of the above adjustments, if made in full, would decrease the partner’s basis below zero, the adjustment is limited to the amount of available basis. In addition, the tax impact to the partner is also limited.

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*Example:* John McFadden contributes $5,000 to a newly formed partnership. In the first year, John’s distributive share of the partnership’s taxable loss is $6,400. Under the basis rules, only $5,000 of that loss would be deductible by John. The remaining $1,400 loss is suspended. John could use that suspended loss to offset future income or it could become deductible if John’s basis is otherwise increased in a future tax year.

Each partner’s share of the partnership’s liabilities is treated as additional basis for the partner’s interest in the partnership. An increase in a partner’s share of the partnership’s liabilities is treated as if that partner had made an additional contribution to the partnership.[[24]](#endnote-24) Any decrease in a partner’s share of the partnership’s liabilities is treated as a distribution made to the partner from the partnership.[[25]](#endnote-25)

*Example:* Assume the same facts as above, except that John’s share of the partnership’s liabilities is $2,000. This would be treated as a contribution made by John to the firm for purposes of determining his basis. His basis would then be $7,000 ($5,000 plus $2,000) before the adjustment for the current year’s loss. Since the adjustment for the current year loss is less than the available basis, all of the current year’s loss would be deductible. John’s adjusted basis at the end of the year is $600 ($7,000 minus $6,400).

One year later, John’s partnership breaks even but is able to pay off all of its liabilities. John must adjust his basis for his share of the decrease in partnership liabilities. However, the $2,000 reduction of John’s liabilities, which is treated as a distribution to John, exceeds his $600 adjusted basis by $1,400 ($600 - $2,000). Since John is not permitted to reduce his adjusted basis below zero and because he already received the tax benefit in the prior year for the additional $1,400 of losses supported by the liabilities, John would be required to report the $1,400 ($2,000 deemed distribution less $600 adjusted basis) as currently reportable income.

Shareholders in S Corporations

Determining a shareholder’s basis in an S corporation is somewhat different from calculating a partner’s basis. An S corporation shareholder may have two different adjusted basis numbers to track, one for his stock basis and one for his debt basis. Unlike a partner of a partnership, an S corporation shareholder does not adjust his basis for the partner’s share of the S corporation’s liabilities.

Typically, an S corporation shareholder’s stock basis begins with the amount the shareholder paid for his stock. The stock basis is then increased or decreased by the following adjustments:

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* increases for the shareholder’s share of the S corporation’s separately stated items of income,[[26]](#endnote-26)
* increases for the shareholder’s share of the S corporation’s non-separately stated items of income,[[27]](#endnote-27)
* increases for the shareholder’s share of the S corporation’s excess of depletion deductions over the basis of the depletable property,[[28]](#endnote-28)
* reductions for distributions not included in the shareholder’s gross income,[[29]](#endnote-29)
* reductions for the shareholder’s share of the S corporation’s separately stated items of loss and deduction,[[30]](#endnote-30)
* reductions for the shareholder’s share of the S corporation’s non-separately computed loss,[[31]](#endnote-31)
* reductions for the shareholder’s share of the S corporation’s expenditures that are not capitalized and not deducted,[[32]](#endnote-32) and
* reductions for the shareholder’s depletion deduction for S corporation oil and gas property to the extent it does not exceed the proportionate share of the adjusted basis of the property allocated to such shareholder under Code section 613A(c)(11)(B).[[33]](#endnote-33)

As was the case with partnership basis, a shareholder’s adjusted stock basis cannot be reduced below zero.[[34]](#endnote-34) If a shareholder’s stock basis is reduced to zero by losses and other adjustments of the S corporation, the shareholder may still be able to deduct the losses allocated to the shareholder assuming the shareholder has sufficient debt basis.

A shareholder may create debt basis by making a direct, bona fide loan to the S corporation. Note, however, that guarantees of S corporation debt or other indirect loans do not give a shareholder debt basis. Any unused portion of the reductions applicable to the shareholder’s stock basis may be used to reduce the shareholder’s debt basis.[[35]](#endnote-35) Again, in no case can the shareholder’s adjusted debt basis fall below zero.[[36]](#endnote-36)

Once a shareholder reduces stock basis to zero and begins to reduce debt basis, any subsequent basis increases are first applied to restore the debt basis to the full amount of the outstanding loan.[[37]](#endnote-37) Once the debt basis is fully restored, stock basis is increased from zero.

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*Example:* Art Werner purchases a 50 percent interest in XYZ, Inc., an S corporation, for $10,000. In the first year, the company passes through a loss of $8,000 to Art. The $8,000 is deductible by Art because he has sufficient basis in his stock (subject to other limitations such as the passive activity rules). At the end of the first year, Art’s adjusted stock basis is $2,000 ($10,000 original basis minus $8,000).

During the second year, Art directly loaned XYZ, Inc. $20,000 and guaranteed another loan of the S corporation for $50,000. Art’s share of the second year loss was $27,000. Art will be able to deduct $22,000 of the $27,000 loss. First, Art’s stock basis is reduced from $2,000 to zero. Second, Art reduces his debt basis from $20,000 to zero. Note that the guarantee of the S corporation loan does not give Mark any additional debt basis. The remaining $5,000 loss is suspended until Art has sufficient increases to his basis to cover it.

In the third year, XYZ, Inc. earned $150,000. Art’s share is $75,000. Of the $75,000, $5,000 is offset by the suspended loss from the second year and is not reported by Art as income. The next $20,000 restores Art’s debt basis and is reported as taxable income. The remaining $50,000 is also reported as income and increases Art’s stock basis by this amount.

It is important to remember that an investor’s ability to create basis through the use of debt is limited by the “at-risk” rules. These rules provide that losses are deductible only to the extent the investor is personally “at-risk.”

The at-risk rules limit deductions for borrowing that attempt to be characterized as “at-risk” for tax purposes when there is no actual economic risk to the investor. For instance, assume Janet Werner, a corporate executive, wants to purchase a $100,000 interest in an oil drilling venture. She intends to invest $20,000 of her own funds while borrowing the $80,000 balance. The bank providing the loan to Janet has agreed to make a “nonrecourse” loan to her. In other words, the bank will rely solely on the value of the property as its collateral for the debt. In the event Janet cannot repay the loan, the bank cannot look to Janet’s other assets to cover the unpaid balance. Since the most Janet can lose on her investment is $20,000 in cash, her deductions will be limited to that $20,000 (plus the amount of income generated from the investment).

The at-risk rules cover essentially all investment activities except for real estate acquired before 1987. With respect to real estate subject to the at-risk rules, “qualified nonrecourse financing” is treated as an additional amount at-risk.

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An investor is considered at-risk to the extent of:

1. Cash invested, *plus*

2. The basis of property invested, *plus*

3. Amounts borrowed for use in the investment that are secured by the investor’s assets (other than the property used in the investment activity), *plus*

4. Amounts borrowed to the extent the investor is personally liable for its repayment, *plus*

When the investment is made in partnership form:

1. The investor-partner’s undistributed share of partnership income, *plus*

2. The investor-partner’s proportionate share of partnership debt, to the extent he is personally liable for its repayment.

An investor is not considered “at-risk” with respect to nonrecourse debt (other than qualified nonrecourse financing, see above) used to finance the activity, or to finance the acquisition of property used in the activity.

Furthermore, an investor will not be considered “at risk” with respect to any other arrangement for the compensation or reimbursement of any economic loss.

*Example:* If Janet, in the example above, is able to obtain commercial insurance against the risk that the oil drilling fund will not return her original $20,000 cash investment, she would not even be considered “at-risk” on that amount.

Losses limited by the at-risk provisions are not lost; instead, these amounts may be carried over and deducted in subsequent years (but only if the investor’s at-risk amount is sufficiently increased).

The benefit of previously deducted losses must be recaptured when the investor’s at-risk amount is reduced below zero.

*Example:* Assume Tania’s loss deductions from her interest in an oil drilling venture total $5,000 through the end of last year. Her basis in the venture at the end of last year (after the deductions) was $1,000. In the current year, Tania received $3,000 in cash distributions. Without any limitations for negative basis, that distribution would reduce Tania’s basis by $3,000 to a figure of *minus* $2,000. But since an investor cannot have a negative basis in an investment for tax purposes, Tania must recapture the $2,000 of prior year deductible losses in order to bring her basis up to zero. In addition, Tania will not be

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able to deduct any losses from the venture in the current year because she has a zero basis.

# Basis of Property Acquired from a Decedent

Under current law, when an investor dies, the beneficiary of his property does not “carry over” the decedent’s basis. Instead, the basis of property acquired from or passing from a decedent is the fair market value of the property as of the date of (a) the investor’s death, or (b) the federal estate tax alternate valuation date if that date (typically six months after the date of death) is elected by the estate’s executor.[[38]](#endnote-38)

Therefore, if the value of an investment held until death increases from the date of its acquisition, the potential gain (or loss in the case of a decrease in value) is never recognized for income tax purposes.

An increase in the property’s basis to its federal estate tax value is called a “step-up” in basis. Note that this “stepped-up basis” is obtained by the recipients of the property after the prior owner’s death even though no one pays income tax on the intervening appreciation.

*Example:* Susan Smith purchased stock that cost $10,000. At the time of her death, the stock had a fair market value of $50,000. Her beneficiary would receive a $50,000 basis for the stock. The $40,000 appreciation in the value of the stock would never be subject to income taxes. If the beneficiary then sold the property for $65,000, his taxable gain would be only $15,000.

The alternate valuation method may be elected by an executor or administrator only if the election will decrease (a) the value of the gross estate and also (b) the amount of the federal estate tax imposed.[[39]](#endnote-39) Generally, an election to use the alternate valuation date means that property will be included in the gross estate at its fair market value as of six months after the decedent’s death.[[40]](#endnote-40) However, if any property is distributed, sold, exchanged, or otherwise disposed of within six months after the decedent’s death, the value of the property at that disposition date becomes the “alternate value.”[[41]](#endnote-41)

*Example:* Assume Les Brun, a widower, buys property for $10,000 and it is worth $50,000 at his death. Assume that his executor sells the asset for $45,000 three months after his death. If the alternate valuation date is elected, the valuation date for this property would be the date of its sale. Its basis becomes $45,000. The estate realizes no tax gain or loss because the $45,000 amount realized on the sale is equal to the property’s $45,000 basis.

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Due to the one-year repeal of the estate tax in 2010, special rules applied to the determination of basis for inherited property acquired from a 2010 decedent. Depending on how the decedent’s estate elected to be treated in 2010, the recipient of the inherited property may have carryover basis instead of the typical stepped-up basis.

# Basis of Property Acquired by Gift

When property is acquired by lifetime gift and there is a gain on the sale by the donee, the general rule is that the property in the hands of the donee has the same basis (subject to an adjustment discussed below) it had in the hands of the donor.[[42]](#endnote-42) The donee of the gift—the new owner—computes his basis by referring to the basis in the hands of the donor. In other words, the donor’s basis is “transferred” and “carried over” to the donee so that gain will not escape tax but merely be deferred. Note that this is now technically defined as “transferred basis” under Code section 7701(a)(43) (although many practitioners continue to refer to this as “carry-over basis”). The gain remains deferred only until the donee disposes of the property in a taxable transaction.

*Example:* Assume that Jared purchases stock for $3,000. After it appreciates in value to $9,000, he gives it to Maria. The basis of the stock in Maria’s hands for determining gain on a later sale by Maria is still $3,000. Therefore, if she sells it for $10,000, she has a $7,000 gain.

When the donor’s basis is used, it is subject to an adjustment for any gift taxes paid on the net appreciation in the value of the gift (but not above the amount of the gift tax paid).[[43]](#endnote-43) For instance, in the example in the paragraph above, if the gift tax were $1,500, the donee’s basis would be the $3,000 carryover basis plus $1,000 adjustment, a total of $4,000.

The addition to basis is computed according to the following formula:

|  |  |  |
| --- | --- | --- |
| Filing status | 2009 | 2008 |
| Married filing jointly | $250,200 | $239,950 |
| Head of household | $208,500 | $199,950 |
| Unmarried | $166,800 | $159,950 |
| Married filing separately | $125,100 | $119,975 |

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In our example, the computation would be:

|  |  |
| --- | --- |
| Married filing jointly | $110,000 |
| Married filing separately | $55,000 |
| All others | $75,000 |

The basis rule for determining loss on the sale of property acquired by gift is different from the rule for determining the amount of the gain on the sale. For purposes of determining the amount of a loss, the basis of the property in the hands of the donee is the lesser of (a) the donor’s basis or (b) the fair market value of the property at the time of the gift.[[44]](#endnote-44) The purpose of this special provision is to prevent investors from gaining a tax benefit by transferring property with a built-in loss to persons who could take advantage of tax losses.

Assume, for instance, that in the example above the value of the stock at the time of the gift was only $1,000. If Jared sold the stock, he would have a capital loss of $2,000 ($3,000 basis – $1,000 amount realized). If Jared had other capital losses of at least $3,000 but no capital gains, the additional $2,000 loss would be treated as a capital loss carryover for the year and would provide no immediate tax benefit to him. Were it not for the special provision, Jared might give the stock to his father who had capital gains. If his father were allowed to use Jared’s $3,000 basis, his father could sell the stock, take a $2,000 loss, and obtain a current tax benefit from the loss that Jared himself could not have used. For this reason, the father, in determining his loss on the sale, must use as his basis the $1,000 fair market value of the property at the time of the gift since that is lower than Jared’s $3,000 basis. If Jared’s father sold the property for $900, he would only recognize a $100 loss on the sale ($900 proceeds less $1,000 basis). If Jared’s father sold the property at a time when it was worth only $1,200 (or any other amount between the $1,000 fair market value at the date of the gift or the $3,000 transferred basis), no gain or loss would be recognized.

# Allocation of Basis

When the assets of a trade or business are acquired, the purchase price must be allocated among the acquired tangible and intangible assets using what is called the “residual allocation” method.[[45]](#endnote-45) This process is extremely important to the acquiring taxpayer since the amounts allocated to each asset create the basis by which future depreciation and amortization expenses are determined.

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The residual method uses a “class” system to identify the amount of the purchase price that is to be allocated to each asset. The purchase price is applied to the assets of each class in proportion to their relative fair market values. The asset classes are:[[46]](#endnote-46)*Class I:* Cash and general deposit accounts, including savings and checking accounts, but excluding certificates of deposit held in banks, savings and loan association and other depository institutions

*Class II:* Actively traded personal property, certificates of deposit and foreign currency

*Class III:* Accounts receivable and assets that the taxpayer marks-to-market at least annually

*Class IV:* Inventory or other property held primarily for sale to customers in the ordinary course of its trade or business

*Class V:* Assets not covered by any other class (typically the fixed assets of the business)

*Class VI:* Section 197 intangibles, except goodwill and going concern value

*Class VII:* Goodwill and going concern value

An independent appraisal of each asset being purchased is a recommended process in order to substantiate and document the allocation of the purchase price. Each of the amounts that are allocated may result in a potentially different tax treatment in the future for the acquirer. For instance, amounts allocated to fixed assets may be depreciable in the hands of the acquirer. In most cases, the taxpayer would then benefit from a relatively short recovery period (depending on the asset involved) and recoup a portion of the investment soon. Conversely, if more of the purchase price falls to goodwill, the acquirer may be faced with a much longer recovery period, if at all.

*Example:* ABC buys the assets of XYZ for $1,000,000. ABC acquires XYZ’s accounts receivable valued at $200,000, inventory valued at $50,000, and fixed assets valued at $400,000. $200,000 of the purchase price is allocated to the accounts receivable and that amount becomes the basis for the receivables. Likewise, the inventory is allocated $50,000 of the purchase price and the fixed assets are allocated $400,000. The remaining amount of the purchase price, $350,000, is allocated to goodwill.

An allocation of basis is also required in circumstances when a taxpayer receives multiple types of property in a single transaction. The best example of this is improved real estate. The building, if used in a business or rental operation, would be eligible for depreciation, while the underlying land is not depreciable. Further, taxpayers may undergo a cost segregation study in order to determine if there are parts of a property that may be classified as depreciable property with a shorter life, thereby increasing the annual depreciation expense.

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# Frequently Asked Questions

**Question** – How is a taxpayer’s basis determined when selling a stock investment?

*Answer* – As previously discussed, the basis of one’s stock investment is determined by the cost of the stock, plus any commissions paid. When a stock is sold and the investor sold less than their entire position in a given security, the stock is deemed to be sold using a first-in, first-out method (FIFO). FIFO is used whenever the investor does not or cannot specifically identify which shares of stock were sold.[[47]](#endnote-47)

An investor may specifically identify the shares that were sold by delivering the shares to be sold to the broker. If the shares are held in street name by the broker, (1) the investor must identify to the broker at the time of the sale which shares are to be sold, and (2) the broker must confirm the share identification to the investor within a reasonable time after the sale.[[48]](#endnote-48)

Beginning in 2011, brokers were required to comply with new cost basis reporting rules for their investors. Prior to this date, the only reporting requirement was for sales proceeds on the sale of securities. Following the schedule below, the information reports provided by brokers must also include the cost basis of the asset sold.

* **Beginning January 1, 2011**, brokers must report information on any common or preferred stock, exchange-traded funds (ETFs), American Depositary Receipts (ADRs) and Real Estate Investment Trusts (REITs).
* **Beginning January 1, 2012**, information about mutual funds and dividend reinvestment plans must also be recorded and reported.
* **Beginning January 1, 2013**, options, fixed income, and any other security otherwise not included in the previous tax years must be recorded by the brokerage and reported to the IRS.

The basis of security purchases prior to the above dates are not required to be reported by the brokers. So, for instance, the basis of a mutual fund purchased in June 2011 does not need to be reported by the broker when sold since the purchase occurred prior to the date of implementation.

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**Question** – How is a taxpayer’s basis determined when selling a mutual fund investment?

*Answer* – An investor’s basis in a mutual fund starts with the original cost of the mutual fund shares, plus any commissions or fees paid. Basis is then increased by any amounts of reinvested income (typically taxable and tax-exempt dividend income and capital gain distributions). Basis may be reduced by distributions treated as return of capital. The sources of these basis adjustments are normally found on Form 1099-DIV or Form 2439, so it is imperative that these forms be maintained to properly maintain accurate basis records.

When less than the full amount of a mutual fund investment is sold, an investor has three choices for allocating basis to determine the capital gain or loss. The three methods are (1) FIFO, (2) specific identification, or (3) average basis. Like the rules for stocks, if the average basis method is not elected or specific identification is not used, basis should be determined on a FIFO basis.

An investor may elect to use the average basis method on a fund by fund basis. The election must be made in the first year that mutual fund shares from a given fund are sold. Every year after the election is made, a taxpayer is required to disclose the continued use of the method on all future sales of the same fund.

There are two average basis methods – single category and double category. The single category method is simply determined by the total basis of the mutual fund shares on the date of the sale divided by the total shares held immediately prior to the sale.[[49]](#endnote-49) The holding period is determined on a FIFO basis. Note that many mutual fund companies provide single category average basis information to their shareholders each year along with their tax information statements.

When double category method is elected, a taxpayer is required to divide his mutual fund holding into short and long-term shares and the average basis for each of these lots are determined. From this point, the taxpayer may opt to sell out of the short or long-term position and use the appropriate average cost basis for those shares.[[50]](#endnote-50) The use of the double category method is not widely used.

With the cost basis reporting requirements placed on the brokers (beginning in 2012 for mutual fund purchases), care must be taken to ensure that the correct cost basis is disclosed to the IRS on the Form 1099-B. Most brokers allow investors to select a cost basis method to be used in lieu of the broker’s default method, which in most cases is single category average cost for purchases after the beginning reporting date.

Basis

**Question** – How is basis determined for a bond issued or purchased at a discount?

*Answer* – A bond issued at less than its stated redemption price is treated as a discounted bond. The amount of the discount is simply the difference between the redemption price and the issue price and is referred to as the original issue discount (OID). Over time, the holder of the bond is required to report the OID in their income and increase their basis in the bond by the same amount. If the bond is held to maturity, the full value of the bond will be paid and there will be no gain or loss (ignoring transaction costs) since the recognition of the full amount of the OID would have increased the taxpayer’s basis to equal the face value of the bond.

If an OID bond is sold before its maturity, the bond’s basis is determined by its original cost plus any OID previously recognized as income.[[51]](#endnote-51)

A bond purchased at a discount on the secondary market is referred to as a market discount bond, and different rules apply. The amount of the market discount may be recognized in the bond holder’s income on an annual basis by making an election on the bond holder’s tax return in the year of the purchase.[[52]](#endnote-52) If an election is not made, the market discount is recognized when the bond matures or is otherwise disposed of by the taxpayer (including via gift). Any gain on the bond is treated as ordinary income to the extent of the market discount.[[53]](#endnote-53) The market discount rules do not apply to: (1) short-term obligations (such as T-bills) with fixed maturity dates one year or less from the date of issue; (2) tax-exempt obligations purchased before May 1, 1993; and (3) U.S. savings bonds.[[54]](#endnote-54)

**Question** – How is basis determined for a bond issued or purchased at a premium?

*Answer* – If a debt instrument is purchased or issued at a price that is greater than the stated maturity amount, the bond holder is paying a premium. The amount of the premium paid on a taxable bond remains as part of the holder’s basis of the bond until it is sold or redeemed unless an election is made to amortize the premium amount.[[55]](#endnote-55) Tax-exempt bond holders are required to amortize the bond premium, even though no corresponding tax deduction results from the amortization. As amortization of a taxable or tax-exempt bond occurs, a bond holder’s basis is reduced accordingly.[[56]](#endnote-56)

Amortization of a taxable bond issued after September 28, 1987 is determined using the constant yield to maturity method and is reported as a reduction to the taxpayer’s interest income each year (bond issued prior to that date may be amortized using any reasonable method).[[57]](#endnote-57) However, the amount of the bond amortization may not be greater than the amount of interest being reported on that particular bond in any given year.[[58]](#endnote-58)

Basis

Essentially, the election to amortize the premium paid on a taxable bond results in a tax deduction against a taxpayer’s ordinary income through the reduction of taxable interest. If the election is not made, the taxpayer will report the bond premium by using a higher basis when the bond matures or is otherwise disposed of, resulting in an offset to their capital gain income and, usually, less of a tax benefit.

Note that for bonds with a call feature, the call date and amount must be used for the amortization calculation.[[59]](#endnote-59)

**Question** – What is the basis of property converted from a nonbusiness use to a business use?

*Answer* – When property that is used personally is converted to business use, the property’s basis is the lower of (1) the basis of the property when it was acquired for personal use, or (2) its fair market value at the time of the conversion.[[60]](#endnote-60)

Basis

1. Treas. Reg. §1.1012-1(a). [↑](#endnote-ref-1)
2. I.R.C. §1016(a)(1). [↑](#endnote-ref-2)
3. I.R.C. §1016(a)(2). [↑](#endnote-ref-3)
4. I.R.C. §168(b)(1). [↑](#endnote-ref-4)
5. I.R.C. §7701(a)(42). [↑](#endnote-ref-5)
6. I.R.C. §1031(d). [↑](#endnote-ref-6)
7. I.R.C. §7701(a)(43). [↑](#endnote-ref-7)
8. Since so many states have decoupled from the federal tax depreciation system, especially with respect to the concept of “bonus” depreciation, many taxpayers are forced to maintain adjusted basis calculations for their fixed assets for state tax purposes. [↑](#endnote-ref-8)
9. I.R.C. §56(a)(1). [↑](#endnote-ref-9)
10. I.R.C. §56(a)(6). [↑](#endnote-ref-10)
11. I.R.C. §56(g)(4)(A). [↑](#endnote-ref-11)
12. I.R.C. §56(b)(3). [↑](#endnote-ref-12)
13. *Ibid.* [↑](#endnote-ref-13)
14. I.R.C. §465(a)(1). [↑](#endnote-ref-14)
15. A partner’s outside basis is defined as the partner’s adjusted basis in the partnership interest. A partner’s inside basis is defined as the partner’s share of the partnership’s adjusted basis in its assets. [↑](#endnote-ref-15)
16. I.R.C. §705(a)(1)(A). [↑](#endnote-ref-16)
17. I.R.C. §705(a)(1)(B). [↑](#endnote-ref-17)
18. I.R.C. §705(a)(1)(C). [↑](#endnote-ref-18)
19. I.R.C. §705(a)(2). [↑](#endnote-ref-19)
20. I.R.C. §705(a)(2)(A). [↑](#endnote-ref-20)
21. I.R.C. §705(a)(2)(B). [↑](#endnote-ref-21)
22. I.R.C. §705(a)(3). [↑](#endnote-ref-22)
23. I.R.C. §§705(a)(2), 705(a)(3). [↑](#endnote-ref-23)
24. I.R.C. §752(a). [↑](#endnote-ref-24)
25. I.R.C. §752(b). [↑](#endnote-ref-25)
26. I.R.C. §1367(a)(1)(A). [↑](#endnote-ref-26)
27. I.R.C. §1367(a)(1)(B). [↑](#endnote-ref-27)
28. I.R.C. §1367(a)(1)(C). [↑](#endnote-ref-28)
29. I.R.C. §1367(a)(2)(A). [↑](#endnote-ref-29)
30. I.R.C. §1367(a)(2)(B). [↑](#endnote-ref-30)
31. I.R.C. §1367(a)(2)(C). [↑](#endnote-ref-31)
32. I.R.C. §1367(a)(2)(D). [↑](#endnote-ref-32)
33. I.R.C. §1367(a)(2)(E). [↑](#endnote-ref-33)
34. I.R.C. §1367(a)(2). [↑](#endnote-ref-34)
35. I.R.C. §1367(b)(2)(A). [↑](#endnote-ref-35)
36. *Ibid.* [↑](#endnote-ref-36)
37. I.R.C. §1367(b)(2)(B). [↑](#endnote-ref-37)
38. I.R.C. §1014(a). [↑](#endnote-ref-38)
39. I.R.C. §2032(c). [↑](#endnote-ref-39)
40. I.R.C. §2032(a)(1). [↑](#endnote-ref-40)
41. I.R.C. §2032(a)(2). [↑](#endnote-ref-41)
42. I.R.C. §1015(a). [↑](#endnote-ref-42)
43. I.R.C. §1015(a). [↑](#endnote-ref-43)
44. I.R.C. §1015(a). [↑](#endnote-ref-44)
45. I.R.C. §1060(a). [↑](#endnote-ref-45)
46. Treas. Reg. §1.1060-1(c)(2). [↑](#endnote-ref-46)
47. Treas. Reg. §1.1012-1(c)(1). [↑](#endnote-ref-47)
48. Treas. Reg. §1.1012-1(c)(3). [↑](#endnote-ref-48)
49. Treas. Reg. §1.1012-1(e)(4). [↑](#endnote-ref-49)
50. Treas. Reg. §1.1012-1(e)(3). [↑](#endnote-ref-50)
51. I.R.C. §1272(d)(2). [↑](#endnote-ref-51)
52. I.R.C. §1278(b). [↑](#endnote-ref-52)
53. I.R.C. §1276(a)(1). [↑](#endnote-ref-53)
54. I.R.C. §1278(a)(1). [↑](#endnote-ref-54)
55. I.R.C. §171(c). [↑](#endnote-ref-55)
56. I.R.C. §1016(a)(5). [↑](#endnote-ref-56)
57. I.R.C. §171(b)(3). [↑](#endnote-ref-57)
58. Treas. Reg. §1.171-2(a)(4). [↑](#endnote-ref-58)
59. I.R.C. §171(b)(1)(B). [↑](#endnote-ref-59)
60. Treas. Reg. §1.165-9(b)(2) and §1.167(g)-1. [↑](#endnote-ref-60)