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Calculating and Adjusting Basis

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TAX BASIS IN THREE PARTS: PROPERTY FROM GENERATION TO GENERATION

The following series has three parts. Article I, by Bradley J. Frigon, discusses the initial calculation of basis, the various adjustments made to basis during a taxpayer's lifetime, the uniform basis rules. Article II, by Nell Graham Sale, discusses carryover basis rules applicable to gifts and the tax basis rules for joint tenancy property. Article III by Sharon Kovacs Gruer explains tax basis rules for property acquired from a decedent, and the new modified carryover basis rules created by the Economic and Growth Tax Relief Reconciliation Act ("EGTRRA") of 2001.

Calculating and Adjusting Basis

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In a sale, exchange, or other disposition of property, a taxpayer's gain or loss is the difference between the amount realized and the taxpayer's adjusted basis in the property. The taxpayer realizes gain when the amount realized exceeds the adjusted basis in the property. A taxpayer realizes a loss when the adjusted basis exceeds the amount realized.

Example: T sells land for $200,000. The amount of gain or loss realized by T will depend on T's adjusted basis in the land. If T's adjusted basis is less than $200,000, then T will realize gain to the extent of the difference. If T's adjusted basis is more than $200,000, then T will realize a loss to the extent of the difference. If T's adjusted basis is equal to $200,000 then T will not realize a gain or loss.

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Computation of Basis

A taxpayer's initial basis in property will depend on how the taxpayer acquires the property, the cost associated with the taxpayer's acquisition of the property, and the existence of any liabilities. Generally, a taxpayer determines or adjusts his or her basis at the time the activity takes place. For example, in a purchase acquisition, the taxpayer establishes his or her basis at the time of the purchase. Although there are almost as many basis rules as there are means by which a taxpayer can acquire property, the following are some of the most common examples, other than when a taxpayer acquires property by gift or from a decedent.

Cost Basis

The basis of property acquired by purchase is the cost the taxpayer paid for the property.[1] Cost includes the purchase price plus any expenses incurred to complete the purchase. The amount of any liability incurred in connection with the acquisition of the property increases a taxpayer's cost basis.[2] As long as the liability is a bona fide obligation of the taxpayer, it is immaterial to the taxpayer whether the property acquired actually secures the obligation or whether the debt is recourse or nonrecourse.[3] In general, the face amount of the liability assumed, taken subject to or incurred by the taxpayer, will increase the taxpayer's basis.

Example: If T purchases property for $100,000 by making a $30,000 down payment plus borrowing $70,000, T's basis will equal $100,000. T's basis will be the same if he made the same down payment of $30,000 and assumed an existing $70,000 mortgage of the seller. T's basis will remain $100,000 even if T did not assume the existing $70,000 mortgage, but simply agreed to take the property subject to the mortgage.

Exchange Basis

When no gain or loss is recognized in a like kind exchange of property, the basis in the property acquired will be the same as the taxpayer's adjusted basis in the property relinquished.[4] If non-like kind property (boot) is conveyed as part of the exchange, the basis of the property acquired will be the same as the taxpayer's basis in the property

1. I.R.C. § 1012.
2. *Commissioner v. Oxford Paper Co.*, 194 F.2d 190, 192 (2d Cir. 1952).
3. Rev. Rul. 69-77, 1969-1 C.B. 59.
4. I.R.C. § 1031(d).

conveyed, "decreased in the amount of money received, and increased in the amount of gain [recognized in the transaction] or decreased in the amount of loss to the taxpayer that was recognized on such an exchange."[5]

Private Annuity Basis

If a taxpayer enters into an obligation to acquire property by annuity payments over the life or lives of the current owner(s) of the property, the taxpayer will adjust his or her basis based upon the purpose of the basis.[6] While the annuitant is still alive, the taxpayer's basis for depreciation purposes will equal the present value of the expected payments, plus the actual payments made by the taxpayer.[7] The taxpayer's basis for purposes of calculating gain is determined by adding the annuity payments actually made to the present value of the remaining payments.[8] After the death of the annuitant, the taxpayer's basis will equal the total amount of annuity payments actually made.[9]

PAST OR FUTURE SERVICES

If a taxpayer receives property in exchange for past or future services, the taxpayer must include the fair market value of the property in gross income. The taxpayer's basis in the property received in exchange for services will equal the amount included in gross income.[10]

ADJUSTMENTS TO BASIS

Adjusted basis is the taxpayer's original basis as determined by how the taxpayer acquired the property and is increased or decreased by certain activities after the taxpayer acquires the property. In general, additional investments in the property, such as capital improvements, increase the taxpayer's basis and certain allowable tax benefits, such as depreciation or amortization, decrease the taxpayer's basis.

CAPITAL IMPROVEMENTS

The cost of any improvements made to the property, regardless of

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5. *Id.*
6. Rev. Rul. 55-119, 1955-1 C.B. 352.
7. *Id.*
8. *Id.*
9. *Id.*
10. Treas. Reg. § 1.83-4(b)(1).

when the improvements are made, increases the taxpayer's cost basis.[11] The Internal Revenue Service (IRS) has issued detailed guidelines to determine which costs must be treated as improvements to property to increase the taxpayer's basis and which costs are currently deductible as repairs, which do not adjust the taxpayer's basis.[12]

DEPRECIATION

Depreciation, amortization, or depletion decreases a taxpayer's cost basis in property.[13] This article will discuss only the depreciation deduction. A taxpayer may decrease his basis in property by the greater of the "allowed depreciation" or "allowable depreciation." The "allowed depreciation" is the amount of depreciation actually claimed by the taxpayer against taxable income. "Allowable depreciation" is the amount of depreciation that the law entitles the taxpayer to deduct regardless of whether the taxpayer took the correct amount of depreciation.[14]

Example: T purchased equipment in 2000 for $50,000. The modified accelerated cost recovery system (MACRS) allowed him to depreciate the cost of the equipment using the 200% declining balance method over seven years. Instead of using MACRS, T accidentally began depreciating the equipment under the alternative depreciation system (i.e., under the straight-line method over ten years).

In 2001, when T discovered his mistake, the amount of depreciation the law allowed him to take was $7,145 (14.29% x $50,000), while the amount he actually took was only $2,500 (5% x $50,000). Because the depreciation allowable is greater than the depreciation allowed, depreciation allowable reduces T's basis, for purposes of determining gain or loss to $42,855 ($50,000 - $7,145).

ALLOCATION OF BASIS

If a taxpayer purchases more than one property in a single transaction, the taxpayer allocates his or her basis among the various properties acquired[15] based upon each property's fair market value.[16] A common example is the acquisition of land with depreciable improvements.

11. I.R.C. § 1016(a)(1).
12. BUR. NAT'L AFFAIRS, Portfolio 504 (2d 2000), Portfolio 505 (1999).
13. I.R.C. § 1016(a)(2).
14. Treas. Reg. § 1.106-3(b)(2).
15. Treas. Reg. § 1.167(a)-5.
16. Treas. Reg. § 1.61-6(a) Ex. 2.

Since the land cannot be depreciated, the taxpayer buying the property will want to allocate more of the purchase price to the depreciable improvements than to the land. If the parties make no allocation of basis, the taxpayer must allocate the purchase price to the land and improvements based upon the fair market value of each item acquired. Similar rules apply to the purchase of land with growing crops or trees.

STOCKS

A taxpayer's sale of stock shares is another common situation that requires the allocation of basis. When a taxpayer sells shares of stock that he or she acquired for different amounts and on different dates, the regulations require the taxpayer to allocate the gain or loss and holding period to basis on a first in first out (FIFO) method.[17] In other words, for purposes of determining the taxpayer's gain or loss and holding period, the last stock purchased by the taxpayer must be the first stock sold. To avoid the application of this rule, the taxpayer must demonstrate that the stock he or she is selling is "adequately identified" from a particular lot.

The regulations define stock as "adequately identified" if the taxpayer can identify a specific certificate or certificates that the taxpayer acquired on a specific date and for a specific price and those specific certificates are delivered to the buyer or broker.[18] Even if the taxpayer acquired all of his or her stock at different times and represented all the stocks by one certificate, the regulations allow a taxpayer to "adequately identif[y]" the particular stock to be sold by maintaining a written record or by book entry.[19]

MUTUAL FUNDS

The taxpayer may elect to use the single-category method or the double-category method for mutual fund shares that the he or she acquires on different dates and at various prices.[20] Under the single-category method, the taxpayer determines the basis of each mutual fund share by dividing the total basis in all shares by the number of shares. The taxpayer considers the first shares acquired as the first shares sold to determine the holding period of the shares sold.[21]

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17. Treas. Reg. § 1.1012-1(c)(1).
18. Treas. Reg. § 1.1012-1(c)(2).
19. Treas. Reg. § 1.1012-1(c)(3)(ii).
20. Treas. Reg. § 1.1012-1(e).
21. Treas. Reg. §§ 1.1012-1(e)(4)(i), (ii).

Under the double-category method, all of the shares of a particular fund are divided into two categories at the time of sale. The first category includes all shares that have a long-term holding period. The second category includes all the shares that have a short-term holding period. The taxpayer calculates the average basis for each category at the time of the sale of fund shares. The IRS allows the taxpayer to specify whether he or she sold the shares from the long-term or short-term category.[22]

Example: T acquires shares in the ABC Mutual Fund as follows:

Acquisition Date	*Number of Shares*	*Total Cost*
Four years ago	2,000	$10,000
Three years ago	500	$7,000
Twenty months ago	200	$4,000
Ten months ago	100	$2,300

The first three acquisitions totaling 2,700 shares fall into the long-term category and have a basis per share of $7.96 ($21,500 ÷ 2,700 shares). The 100 shares in the short-term category have a basis of $23 per share.

If T sells 300 shares for $30 per share and specifies that the shares sold should be taken from the long-term category, he will have a long-term gain of $6,612 ($9,000 - $2,388 (300 shares at $7.96 a share)). After T has held his fourth purchase of 100 shares for more than twelve months, T moves the short-term shares into the long-term share category. Assuming no additional purchases, T will have only one category consisting of 2,500 shares with a basis of $8.57 per share. T calculates this basis per share by adding the basis of $19,112 for the 2,400 shares already in the long-term category, plus $2,300 for the incoming 100 shares divided by 2,500 shares.

Although many mutual fund companies provide their shareholders with average basis information based on the single category method, generally it is more advantageous for a taxpayer to calculate his or her gain or loss based upon their actual basis. To keep track of a taxpayer's basis in a mutual fund, the taxpayer must keep all the annual statements. This is especially necessary when the taxpayer automatically reinvests dividends and/or capital gains in their mutual fund or periodically buys additional shares of the fund. The statements show the price paid for the shares, the date of acquisition, and the number of shares acquired.

22. Treas. Reg. § 1.1012-1(e)(3).

WASH SALE TRANSACTION

If a taxpayer disposes of stock or securities at a loss, and immediately purchases substantially identical securities, the taxpayer cannot recognize his or her loss under the wash sale rules of Internal Revenue Code (IRC) § 1091. In a wash sale transaction, the taxpayer's basis in the stock acquired will equal the stock disposed of, increased by any excess paid over the amount realized, and decreased by any excess of the amount realized over the amount paid.[23]

Example: Three years ago, T purchased one share of stock in XYZ Corporation for $100. T sells the stock for $80 and within five days buys one share of stock in ABC Corporation for $120. Because T purchased substantially identical stock within the prohibited period, T cannot recognize his realized loss of $20. T's basis in ABC Corporation is $140 ($100 + $40 excess of the $120 paid for the new stock over the $80 amount realized from the sale of XYZ stock).

HOME OFFICES

A taxpayer who uses part of his or her home for a business must allocate his or her basis between the part used as a home office, workshop, or storage area and the part used as his or her principal residence. The IRS takes the position that the IRC § 121 exclusion is not available for any portion of the residence used for business purposes during the qualifying use period.[24]

Example: Taxpayer H buys a house in 1998. For five years, H uses a portion of the property as his principal residence and a portion of the property for business purposes. H claims depreciation deductions of $20,000 for the business use of the property. H sells the property in 2003 realizing a gain of $50,000. H had no other IRC § 1231 gains, capital gains or losses for 2003. H determines that $15,000 of the gain is allocable to the business-use portion of the property and that $35,000 of the gain is allocable to the portion of the property used as his residence. H must recognize $15,000 of gain allocable to the business-use portion of the property. In addition, the IRC § 121 exclusion does not apply to the extent that H's post-May 6, 1997 depreciation deduction of $20,000 exceeds the gain allocable to the business-use portion of the property ($15,000). Therefore, H may exclude $30,000

23. I.R.C. § 1091(d).
24. Treas. Reg. § 1.121-1(e).

of the gain from the sale of the property under IRC § 121 and must recognize $20,000 of gain.[25]

Although similar rules applied to business use of a residence under prior IRC §§ 1034 and 121, a taxpayer could avoid the recognition of gain by stopping all business use of the property immediately prior to sale.[26] Under current law, a taxpayer must cease all business use of the property two full years prior to the sale to avoid recognition of gain under IRC § 121.

UNIFORM BASIS RULE

When successive multiple interests are created in property, such as life estate and remainder interests, the tax basis is uniform with respect to each individual holding an interest in the property.[27] The basis of property acquired from a decedent must be "uniform in the hands of every person" that acquired or received the property from the decedent.[28] Likewise, the basis of property acquired by a gift must be uniform in the hands of every person who acquired an interest in the property from the gift.[29]

DISPOSITION OF PARTIAL INTEREST

Even though the basis remains uniform, the basis is adjusted among the life tenant and remainder persons by accounting for changes in the relative values of the interests over time.[30] The tables provided by the IRS allow taxpayers to make this adjustment.[31] The tables assign actuarial assumption to life expectancy and the current applicable federal mid-term rate of interest. The factor assigned by the tables is then multiplied by the entire adjusted uniform basis.[32]

Although a portion of the adjusted uniform basis is allocable to the life interest or term interest, IRC § 1001(e) requires that a life tenant or term holder disregard the allocated basis when computing gain or loss realized to the extent it reflects gift basis or basis from a decedent, unless there is a complete disposition of all interests in the property.

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25. Treas. Reg. § 1.121-1(f) Ex. 8.
26. Rev. Rul. 82-26, 1982-1 C.B. 114.
27. Treas. Reg. §§ 1.1014-4(a), -5(a).
28. Treas. Reg. § 1.1014-4(a)(1).
29. Treas. Reg. § 1.1015-1(b).
30. *See* Treas. Reg. § 20.2031-7(d), for tables.
31. Treas. Reg. § 1.1014-5(a)(2).
32. *See* Treas. Reg. § 20.2031-7 for tables.

Example (1): D dies leaving dividend paying stock to L for life, remainder to R. The stock has a fair market value (FMV) of $100,000 at D's death. When D dies, L is 58 years of age. The uniform basis in the stock is $100,000. Using Table S of Treas. Reg. § 20.2031-7(d), and assuming the appropriate IRC § 7520 interest rate is 5%, the factor for L's life estate is .60318 and for R's remainder is .39682. Ten years later, when the stock has a FMV of $300,000, L sells her life estate for $140,853 ($300,000 x .46951, the factor for someone age 68 and assuming a 5% interest rate). "[T]he portion of the adjusted uniform basis allocable" to L's life interest is $46,951 ($100,000 x .46951), but L must recognize gain of $140,853 because IRC § 1000(e) requires the taxpayer to disregard the basis.[33]

Example (2): Same facts as in Example (1), and assume that L does not sell her life estate interest but that five years after D's death, when the stock has a fair market value of $220,000, R sells his remainder interest for $101,642 ($220,000 x .46201, the remainder factor applicable when the life tenant is aged 63, and assuming a 5% interest rate). The portion of the uniform basis allocable to R's remainder interest is $46,201 ($100,000 x .4601). R must recognize gain of $55,441 ($101,642 - $46,201).[34]

Example (3): Same facts as Example (1), except that when L sells her life estate, R sells his remainder interest to the same purchaser for $159,147. Under IRC § 1001(e)(3), the IRS permits L to take her allocable share of the uniform basis into account. Thus, L recognizes gain of $93,902 ($140,853 -$46,951). The portion of the uniform basis allocable to R's remainder interest is $53,049 ($100,000 x .53049). R must recognize gain of $106,098 ($159,147 - $53,049).[35]

ENTIRE PROPERTY INCLUDED IN THE DECEDENT'S GROSS ESTATE

If more than one person acquires an interest in property prior to the decedent's death, but the decedent's estate still includes the property for estate tax purposes because the decedent retained a power over the property, the taxpayer must compute the basis of the property under the uniform basis rule at the time of the gift and then the taxpayer must recompute it at the time of the decedent's death.[36]

Example: During D's lifetime, D conveys Blackacre to L for life, remainder to R. However, D retains the right to occupy the property

33. BUR. NATI'L AFFAIRS, Portfolio 560, page 113 (1998).
34. *Id.*
35. *Id.*
36. Treas. Reg. §§ 1.1014-6(b)(1), (2).

and collect rents. At the time of the gift, D's basis in the Blackacre was \$50,000. Under the uniform basis rule, L's share of the basis would be \$32,000 and R's share of the basis would be \$18,000. Assume that no transactions occur to require an adjustment to the basis during D's life. When D dies, D's estate will include the entire value of Blackacre under IRC § 2036 because D retained the right to occupy the property and collect rents. At the time of D's death, the property had a fair market value of \$200,000. The basis of the property to R and L increases to \$200,000 and it allocates \$128,000 to L's life estate interest (\$200,000 x \$32,000/\$50,000) and \$72,000 to R's remainder interest (\$200,000 x \$18,000/\$50,000) under the uniform basis rules.

GRATUITOUS TRANSFERS OF REMAINDER INTERESTS

If a taxpayer transfers property for life, with remainder in fee, and the remainder owner predeceases the life tenant, the property's uniform basis is not adjusted because of the death of the remainder owner.[37] However, the basis of the remainder in the hands of the heir or devisee of the remainder owner equals the portion of the uniform basis assigned to the remainder under Treas. Reg. § 20.2031-7. That basis is increased by any excess value of the remainder interest included in the remainder owner's gross estate over the basis in the remainder interest immediately before the remainder owner's death, or decreased by any excess of the basis in the remainder interest immediately before the remainder owner's death over the value of the remainder interest included in the remainder owner's gross estate.[38]

37. Treas. Reg. § 1.1014-8(a)(1).
38. *Id.*