Module 3.4: Basis

There are three basic reasons why you need to know how basis works: buying or selling equipment and property, determining how to take depreciation to your advantage, and determining the value of your investment in a partnership or S corporation.

In this module, we will discuss:

- What basis is and why it is important
- How to determine what your basis is in different scenarios
- How basis increases and decreases

We will continue our discussion about basis in module 3.5 to see how it is used in partnership transactions, in module 3.6 and how it is used with depreciation, and finish up in module 3.8 with how it affects S corporation taxability.   Basis affects a lot of areas of business.

What is Basis?

For tax purposes, basis is the amount of a taxpayer's investment in property. When you purchase property (or equipment), the basis is the purchase price + any cost to acquire it. However, there are other ways to obtain property, such as receiving it as a gift or inheritance in which the basis is established in other ways - which we will discuss.

You may also convert personal-use property to business-use property. One of the most common forms of this is when a taxpayer converts their personal residence into a rental property. There are special calculations that have to be made in a situation like this, because the basis for depreciation may be different from the basis for gain or loss. Don't worry. By the time we're finished, that will make a whole lot more sense.

Why is Basis so Important?

Establishing the basis of property is necessary to find out if you made a profit or a loss when the property is sold. If you don't have a recorded basis for the sale of an asset, the IRS assumes you paid nothing for it, so wants you to pay tax on the entire sale price.

For instance, if you purchased a riding mower for your landscaping business for $5,000 and then turned around and sold it for $3,000. If you didn't report your basis of what you purchased it for, the IRS would assume you made a $3,000 profit, when in actuality, you had a $2,000 loss.   Ouch.

Determining Cost Basis

Let's start with the simplest example of cost basis - buying stock in a corporation:

Robert paid $10,000 for 100 shares of ABC Company stock. He did not pay any additional commissions or fees. Robert's basis in the stock is $10,000.

Cheryl paid $20,000 plus $700 commission to purchase 100 shares of JJ Company stock. Cheryl's basis in the stock is $20,700 because commissions, recording and transfer fees can be added.

Real Estate Acquisition Costs

When buying real estate, the settlement statement (or closing disclosure) shows a whole list of other charges you have to pay at closing. Many of these can be added to the sales price to arrive at the proper basis for the property. Settlement statements have a section for the seller and a section for the buyer. When buying business property, you may add some of the closing costs paid by the buyer at closing. These often include property taxes, sales commissions, fees to obtain a mortgage loan such as points, and title, transfer or recording fees.

Some of these charges can be deducted on your business return for the year of purchase and some of the charges are added to your property's basis. Here is a summary of important and common real estate acquisition costs and how they are treated by the buyer:

Real estate taxes paid in advance by seller, reimbursed by buyer.	Deductible in year of purchase.
Assessments paid by seller, reimbursed by buyer	Added to property basis.
Real estate taxes owned by seller, paid by buyer	Added to property basis.
Sales commissions paid by buyer	Added to property basis.
Fees or charges paid by buyer to obtain a mortgage loan, i.e. origination fees or points	Deductible in year of purchase.
Interest for the period from settlement date to first mortgage payment	Deductible in year of purchase.
Title, transfer, and recording fees	Deductible in year of purchase.
May be added to basis if not included elsewhere:	
Utilities used but not paid by seller	Added to property basis.
Advance rent collected by the seller from a tenant for a period extending beyond the settlement date.	Added to property basis.

When your business purchases real estate, your tax preparer should be asking to see a copy of your settlement statement. If they don't, then you need to find a better tax preparer.

The other thing to remember is that you have to separate the cost of the land from the cost of the property and allocate cost of purchase between the two. Let me give you an example:

Jackie purchased a house and lot for $225,000 cash.

Her legal expenses to purchase the property were $7,000, which makes her initial basis $232,000. Since she plans to use this as rental property, it is necessary to separate the basis of the land from the basis of the house.

When she bought the house, the value of the lot was not stated separately. However, vacant lots of the same size in the area sell for $50,000, so we can use that as the cost of the lot. So the purchase price of the house is $175,000 [$225,000 total - $50,000 land = $175,000]. If there were not other expenses, then you would simple put these two figures in your depreciation tables and be done.

However, since most retail estate involves extra expenses, you need to know how to split the expenses between the land and house so you put the right proportions on the depreciation tables.

This also means that the land costs 22.22% of the total price. [$50,000 / $225,000 = 22.22%] So the basis of the land is $51,555. [$50,000 + ($7,000 legal expenses x 22.22%) = $51,555]

If the land is 22.22% of the total, that means the house percentage is 77.78% [$175,000 house / $225,000 total = 77.78%]

So the basis of the house is $180,455 [$175,000 purchase price + ($7,000 legal expenses x 77.78% house percentage = $180,445]

The reason we have to do all this math is because land does not wear out, so it is not depreciable. This make a big difference when it comes time to sell the property. After all, you don’t want to pay any more taxes than you have to when that time comes.

How to Handle Real Estate Improvements

First of all, I am not talking about people who buy houses, fix them up, and then resell them - normally referred to as flipping a house. Those are treated from a tax standpoint the same way you would handle buying parts to manufacture products to sell at a finished price.

These improvements refer to office buildings that house businesses and rental properties. The purchase of real estate often includes not only the land, but also improvements to that land, such as buildings, parking lots, fences, etc.

When this happens, the cost must also be allocated among the assets. This allocation is made based on the ratio of each asset’s fair market value (FMV) to the total cost. Basis need to be allocated between the land and the improvements, like the previous example, so that the improvements can be properly depreciated.

So what happens if you make improvements to the property after you have purchased it? If they are minor costs like repairing a leaky pipe or the air conditioner, then you can just expense them. However, if you do a major change in excess of $2,500 like a new roof, new air conditioner, or adding a room - then you add up the cost of the entire project and make a new line item on the depreciation table for the total price of the improvement. There are only percentage allocations on the initial purchase that involves land as a percentage of the purchase.

Again, if your tax preparer is not talking to you about what the land cost is to figure allocations properly, then you need to find a better tax preparer.

Receiving Property as a Gift

Most of the time, you will receive gifts to you personally instead of them being gifted to a business but this is good to know for both situations. Probably the easiest way to discuss gifts is to show an example. To make it easier to understand, we are going to use stock sales this time rather than depreciable property.

George sold 100 shares of XYZ, Inc last year for $5,000. His parents had given him the shares as a college graduation present quite a few years ago. For gifts, the person receiving the gift has no tax liability when they receive it, but only when they sell it. To determine if you owe any tax and how much, you have to determine the basis of the stock to find out if you have a profit or a loss.

And with all things taxes, the basis for figuring gain or loss is not simple. The basis of the property sold is different depending on whether there was a gain or a loss. You are also going to need the following information to figure it all out:

- The adjusted basis at the time you were given the gift (the donor's basis).
- The fair market value (FMV) of the property at the time you received the gift (in this case, what the stock was selling for the day you received it).

If the FMV is Equal to or More Than the Donor's Adjusted Basis, then the basis for the person receiving the gift is the donor's basis at the time of the gift.

In our example, let's assume that George's parents bought the stock when James was a child in anticipation of giving it to him when he started out on his own. When the parents gave the stock to George, their basis was $3,600 and the FMV was $11,200.

Under this rule, George's basis in the stock for gain and loss is $3,600. Since he sold it for $5,000, then he would owe taxes on $1,400.

Now, if the FMV is Less Than the Donor's Basis, the basis depends on whether there is a gain or loss on the sale of the property. If there is a gain, you figure it the same way as our last example using the donor's basis.

But what if we change the circumstances. Let's say the parents paid (donor's basis) $7,500 for the stock and when sold the FMV was $6,500. Since he sold the stock for $5,000 he had a loss, but this time he has to use the FMV as the basis. He would end up with a $1,500 loss instead of the higher loss if he had been able to use the parents basis.

See what they did? If you have a gain, then you have to choose the way that taxes you on the larger amount. If you have a loss, then you have to choose the way that gives you the least amount of loss.

If you have been given business-use depreciable property, the basis to the business receiving it is the adjusted basis of the person who gave it, plus or minus any required adjustments to basis while your business holds the property.

Transferring Property Between Spouses

While you will probably not need to know this for business purposes, I like to cover all the bases so I'll take a couple of minutes to cover it.

Generally, property transferred from one spouse to the other, regardless of whether the transfer is due to a divorce proceeding, is treated as a gift, but special rules apply.

The basis of the property for the spouse receiving it is always the adjusted basis of the spouse giving it. The FMV does not figure anywhere into the calculation.

Note: To clarify, this does not apply to a nonresident alien spouse or former spouse.

The rules apply to property transferred for giving up marital rights, for cash or other property, for the assumption of a liability in excess of the basis, and for the discharge of debt. There are also a set of rules to establish basis of this type of gifted property, but are outside the scope of this course.

Figuring the Basis of Inherited Property

There are two methods that the basis of inherited property is determined, depending on the type of income received. There is property that the decedent owned and there is income-producing property. For instance, stocks would be property owned, but monthly payments from an IRA or 401(k) would be considered income-producing property.

Let's take a look at the general rule for assets other than income-producing property:

The assets of a decedent's estate are usually valued on the day of death. However, the executor of the estate can elect to value the assets on the day six months after the day of death. This six-month day is called the alternative valuation date, but rarely used.

This is referred to as the stepped-up basis and it is based on the fair market value (FMV) of the asset on the day of death. For instance, you inherited 200 shares of stock and it was originally purchased for $100 a share. On the day the decedent dies, the FMV was $200, so the basis to you would be $200 a share when you sell it. This can make a huge difference in capital gains tax owed when sold.

Another common example is when the parents die and you inherit their house. Your basis becomes the FMV of what the house would sell for on the day of death, instead of what it was originally purchased for. If the house is sold right away, and once you add the cost of sale to the FMV, you normally will come up with a capital loss.

From a business standpoint, many people decide to turn an inherited house into a rental unit. In this scenario, the new basis for the rental property would be the FMV plus any cost of transfer split between the land and house as we discussed before.

The heirs of property valued under the special methods for farms and closely held businesses should receive a basis statement from the executor of the estate.

The other type of inherited property are assets considered 'Income in Respect of a Decedent' (IRD), such as an IRA or 401(k).   These do *not* receive a stepped up basis and the heirs continue to receive the monthly payments just as if they were being sent to the person that died. The basis of the accounts just carry over from the decedent to the person inheriting it.

Basis of Property Converted From Personal to Business Use

When people get married that each own their own house, they may decide to rent one of them if they can't get a decent price selling it. Or sometimes, a family decides to buy a new house, can't sell the original, and decide to rent it out for some extra income. Let's discuss how we determine the basis in this situation.

When personal-use property is converted to business-use property, the property's basis for depreciation is the lesser of:

- The adjusted basis
- The FMV on the date of the conversion

For example, assume you bought a condo seven years ago for $175,000. The building was 20 years old, and the condo had not been updated during that time. You didn't mind and hadn't

done any work on it yourself. However, when the condo didn't sell after five months, the real estate agent advised you that the condo was at a serious disadvantage because it was so out-of-date. So, you decide to spend $15,000 remodeling the kitchen and bath. This represents the total of your additional investment in the property.

Your real estate analyzed recent sales of comparable properties in the area and established the FMV of the condo was $245,000. The agent compared similar properties at the time the condo was listed and at the time you decided to convert it to a rental.

The basis for your depreciation would be $190,000 ($175,000 + $15,000) since the adjusted basis is less than the FMV. Again, the method that would create the most amount of taxable income if sold.

Pre-rental expenses, such as the kitchen and bath remodel in the previous example, are made when a taxpayer is preparing a property for rental, but the property has not yet been made available for rent. Because the property is not yet available for rent, it is not considered to be placed in service as rental property. Expenses made during this time period are added to the adjusted basis or FMV and deducted through depreciation over 27.5 years for residential rentals or 39 years for commercial rentals.

Increases to Basis

Through this module, we have been referring to adjusted basis. As your business grows and progresses, there are many things that will increase your basis and others that will decrease your basis. It is vitally important that you keep adjusting your basis as these events occur for two basic reasons:

- You need a proper basis so that you don't pay too much tax in case you sell the asset
- You can't take a loss in excess of your basis in partnerships and S corporations (more about that later)

Items that increase basis include:

- Cost of improvements to the property.
- Assessments for local improvements, such as sewers and sidewalks, and the cost of extending utility service lines to the property.
- Legal fees, including those for defending a title or obtaining a decrease in an assessment levied for local improvements.
- Zoning costs to bring a property into compliance with government regulations.
- Casualty restoration beyond bringing the property back to pre-casualty condition.

- Deferred gain for disposed property.
- The cost to demolish buildings, which is added to the *land* basis.
- Interest and taxes on unimproved and unproductive real estate that a taxpayer elects to capitalize rather than deduct.
- Cost to remove structural barriers for the elderly or disabled that a taxpayer elects to capitalize rather than deduct.
- Gift taxes paid.

It is important to distinguish improvements from repairs, because repairs can be expensed, but improvements have to be capitalized and deducted over many years.

Improvements to property substantially prolong the property's useful life and/or materially add to the value. Essentially, improvements increase the property's basis.

Repairs and maintenance, on the other hand, **do not** substantially prolong the property's useful life or materially add to its value. Instead, repairs keep assets in good working condition. Examples include replacing a window pane glass, patching the roof, painting the walls, and repairing the furnace.

Examples of improvements include adding a room, replacing the entire roof, putting in upgraded windows, replacing the water heater, installing a fence, pouring a new driveway, or replacing appliances.

However, if the repairs or maintenance are part of an extensive remodeling or restoration of the property, the repair costs are treated as part of the improvement that increase the basis. For example, let's say that before you rented the house, you remodeled the bathroom. You purchase a new vanity, fixtures, and flooring at a cost of $2,000, and fresh paint and a new door for the linen closet for $150. The $150 cost to print and replace the closet door cannot be separated from the other remodeling costs. Instead, the $2,150 cost of the entire project is capitalized and recovered through depreciation.

This is also an example what why we talked about separating out depreciable items when setting up your accounting system. We'll examine this more later.

Decreases to Basis

Items that decrease basis include:

- Allowable deductions for depreciation, amortization, and depletion. This is the amount you deduct each year such as the 27 1/2 years for rental property.
- Certain tax credits and deductions for purchasing or modifying property.
- Rebates from manufacturers and sellers.
- Nontaxable corporate distributions including stock dividends and stock splits.
- Payments received for easements.Insurance reimbursements and other recoveries for casualty or theft loss, including unreimbursed payment of insurance deductibles.
- Cancelled debt excluded from income.
- Postponed gain from the sale of a main home prior to May 7, 1997.

Tax Credits

Tax credits the taxpayer received because they purchased property or made modifications to property decrease basis. The basis is reduced by the amount of credit. This is to make sure you don't get the tax advantage of the credit twice. Examples include tax credits for:

- Electric and alternative fuel vehicles.
- Energy-efficient improvements to residences.
- Historic rehabilitation of buildings.
- Disabled access.

For example, in 2019, Joe paid $10,000 to purchase and install a solar electric system that uses solar energy to generate electricity for use in his main residence. The solar electric system qualified for the Residential Energy Efficient Property Credit.

Joe claimed the $3,000 credit on his 2019 tax return. Joe's basis in his house increased by $7,000 [$10,000 solar energy system - $3,000 tax credit].

Depreciation

Several places in this module I have mentioned depreciation, which also reduces basis. Because there are several ways that depreciation can be used to control how much tax you pay in any particular year, I have created a separate module for it (Module 3.6).

This module has presented the basic knowledge every business person really needs to know. There are additional factors to consider when we get into partnership and corporation returns, but we will address those in their respective modules.

But, I wanted to end our discussion of basis here by reviewing how corporate distributions affect you if you own stock in a company.

Adjustments to Corporate Basis

There are some corporate distributions that are nontaxable, but affect the basis of the underlying stock. You may have read or heard about these subjects.

Stock Splits and Nontaxable Distributions

A corporation usually spits its stock by issuing additional shares for each outstanding share, but in some cases a corporation may lower the number of outstanding shares. The base is determined by dividing the cost of the original shares by the number of shares outstanding after the split. The same method is used when a stockholder receives nontaxable stock dividends which they reinvest in stock.

Let me give you an example: Steve bought 100 shares of ABC company for $25 per share plus a $100 transaction commission. Steve's basis in the 100 shares is then $26 per share after accounting for the transaction fee. For the next five years, the company paid nontaxable dividends of $1 per share, which were reinvested to purchase more stock. Because the additional shares were purchased with nontaxable money, they are considered to be purchased for free.

At the end of five years Steve held 120 shares with a basis with a basis of $2,600, or $21.67 a share. Then the company announces a two-for-one stock split, So Steve now has 240 shares. But his basis still remains the same because he did not invest anymore money that taxes have been paid on. So, in this example, his bias in the shares remains at $2,600, but his price per share is now only $10.83 per share. This is important to keep track of for when you sell the stock.

Nondividend Distributions

Sometimes a corporation will make a distribution other than a taxable dividend. When this happens, the portion of the distribution which is not a dividend will reduce the adjusted basis of the stock (but not below zero). Essentially, this would be considered return of capital or getting back some of the money you purchased the stock with.

For example: Doris bought 100 shares in the RP Corporation for $10 a share. Her basis in her stock is $1,000. She receives an $850 distribution of which only $100 is a dividend. Doris includes the $100 dividend in income, and the basis of her stock is reduced from $1,000 to $250 by the $750 nondividend portion of the distribution. So, her shares are now only worth $2.50 a share.

Final Thoughts

I realize that this is a lot to take in for most people, but for any kind of investments or business, you need to have at least a working knowledge of basis as it affects so many things. Having an introduction to it here will help you understand many of the subjects we will be covering in the following modules.

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