

**Basis**

**Without**

**A Taxpayer has NOTHING!**

**A Resource for the Tax Professional**

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# **BASIS; WITHOUT, A TAXPAYER HAS NOTHING**

## **Chapter 1. Capital Assets**

- I. Generally, everything you own and use for either personal purposes or investment purposes is a capital asset.
  - A. Some examples of capital assets would be:
    1. Stocks and bonds,
    2. Principal residences,
    3. Secondary or vacation residences (unless used as a rental),
    4. Household furnishings,
    5. Automobiles used for commuting or for personal purposes,
    6. Coin collections, and
    7. Gems or jewelry.
  - B. Under the Internal Revenue Code, all property is considered a capital asset except for the following five types of property, which are specifically excluded from the definition of capital asset:
    1. Stock in trade or other inventory property, and property held primarily for sale to customers in the ordinary course of your business.

**Example #1:** Consider the real estate developer who normally buys property, subdivides that property, and then sells off the lots. If the developer holds some of the property for more than one year, will he be able to use the preferred capital gains rate for this sale? No. Why? Because this property is, for the developer, part of his stock in trade, held primarily for sale to customers in the ordinary course of his business. Do not consider your “stock in trade” as a capital asset.

2. Accounts or notes receivable acquired in the ordinary course of your trade or business for services rendered, or from the sale of any of the types of property described are excluded from sales of capital assets.

**Example #2:** Using the real estate developer again, assuming the developer decides to sell one of his lots by taking back a note against the property. Even if he holds this note for more than one year and then sells it to someone else for a profit, the developer does not have a long-term capital gain on the sale of the note. The note receivable was acquired in the ordinary course of the developer’s trade or business.

3. Depreciable personal property used in your trade or business (even if fully depreciated), and real property used in your trade or business is also excluded from the definition of capital assets.

***Tax Professional's Alert:*** *Rental property is a type of investment, however, rental property would be considered "trade or business" property and would not be considered a capital asset. It is possible to receive long-term capital gain rates on the economic gain on the sale of the property, but any depreciation that you recover will not be treated as capital gain income.*

**Example #3.** You purchased a rental property in 2001 for \$50,000. Over the years you claimed \$9,000 in depreciation expense on the property. In 2010, you sell the property for \$55,000. Your total gain on the sale of the property would amount to \$14,000, but the first \$9,000 of gain would be treated as recaptured depreciation, subject to special tax rates, but not the rates applied to normal long-term capital gains. But the remaining \$5,000 would, in fact, qualify for long-term capital gain treatment.

***Tax Professional's Alert:*** *These rules can get even more complicated for personal property used in a trade or business (such as a business auto, business furniture and fixtures, your business computer, etc). If you have business assets, be aware that there are special rules regarding the computation for the gain on the sale of these assets.*

4. A copyright, literary, musical or artistic composition, letter or memorandum, or similar property that is:
  - a. Created by your personal efforts,
  - b. Letters, memorandums, or similar property prepared or produced for you, or
  - c. Acquired from a person who created the property, or for whom the property was prepared, under circumstances in which your basis in the property is determined in whole or in part by reference to the basis of the person who created the property, or for whom it was prepared or produced (e.g., by gift).

***Tax Professional's Alert:*** *If you write the Great American Novel and hold on to the manuscript for more than a year, and then sell it, you will not receive long-term capital gain treatment because you created the novel. The novel is not a capital asset in your hands.*

5. U. S. Government publication that you got from the government for free or for less than the normal sales price.  
(These publications are not normally a large income generator.)

## Chapter 2. Taxation

- I. The type of asset sold determines rules regarding the sale of any asset.
  - A. Selling a capital asset and have held it for more than one year, then preferred tax treatment will be on those gains.
  - B. Such assets include but are not be limited to:
    1. Coin or stamp collections,
    2. Jewelry and art,
    3. Stocks and bonds,
    4. Your home (if you cannot exclude all of the gain), and
    5. Household furnishings.
  
- II. Capital gains rates:

<u>Type of Asset</u>	<u>Holding Period</u>	<u>Date of Sale</u>	<u>Rate</u>
Capital Asset	12 Months	On or after 1/1/08	15% or 0%*
<ul style="list-style-type: none"> <li>• Zero percent tax rate on capital gains for 10% + 15% tax bracket.</li> </ul>			
1250 Unrecaptured Gain	12 Months		25%
Collectibles	12 Months	Anytime	28%
Small Business (1) Stock (50% or 75% Deduction applies)	Five Years Stock issued after 8/10/93 - C Corp only	After 8/10/98	14%

(1) Election to roll over gain after holding stock for more than 6 months to another Section 1202 stock within 60 days (holding period can be cumulative under Section 1045).

Holding Periods for 1998 and thereafter are as follows:

Short-term.....Assets held 12 months or less.  
 Long-term.....Assets held more than 12 months which were sold after 12/31/97.

Types of Capital Gains and Alternative Tax Rates.

1. Net short-term capital gain is not eligible for any special tax rate. It is taxed at the same rate as the taxpayer's other taxable income.
2. Net long-term capital gain is generally eligible for one or more of four alternative tax rates:
  - a. 0- percent after 12/31/07 is 15% tax bracket or lesser (through 2012),
  - b. 15 percent after 12/31/07 for tax brackets over 15% (through 2012),
  - c. 25 percent (unrecaptured Section 1250 gain), and
  - d. 28 percent (collectible and Section 1202 gain).
3. The net long-term capital gain components are referred to as the 10%/20% gain, the 25% gain, and the 28% gain, and after 12/31/07, the 15% and 0% gains also.
4. The 25% gain is technically called the unrecaptured Section 1250 gain (ordinary gain) and is related to gain from disposition of depreciable real estate Section 1231 assets.
5. The 28% gain relates to collectibles and small business stock (Section 1202) gain.
6. When the long-term capital gain exceeds short-term capital loss, a net capital gain (NCG) exists. Net capital gain qualifies for beneficial alternative tax treatment.

**Tax Professional's Alert: The 2010 Tax Relief Act gives a temporary exclusion of 100% of gain on certain small business stock, extending the following provision:**

**For 2010, a taxpayer could exclude all of the gain on the disposition of qualified small business stock acquired after September 27, 2010 and before January 1, 2011, and 75% of the gain from such stock acquired after February 17, 2009 and before September 28, 2010. Under pre-Act law, the exclusion would be limited to 50% of gain for stock acquired after December 31, 2010.**

**The 2010 Tax Relief Act extends this provision for one year so that taxpayers may continue to exclude 100% of gain from the disposition of qualified small business stock acquired before January 1, 2012 (Code Section 1202(a)(4), as amended by Act Sec. 760).**

### **Chapter 3. Holding Period Rules for Long-Term Capital Gains**

#### **I. General holding period rule**

- A. To yield “long term” capital gain, an asset must be held for more than one year, in other words, for at least a year and a day. The holding period begins on the day after you buy an asset, and ends on the day you sell it. If you bought stock on January 4, 2009, your holding period began on January 5 (the day after you bought).
- B. If you sell at a profit on or after January 5, 2010, your gain will be long-term capital gain. If you sell on January 4, 2010, your gain or loss is short-term, taxed at the same rate as ordinary income. Keep in mind that for publicly traded securities, the holding period begins on the day after the trading date you bought the securities, and ends on the trading date you sold them.

***Tax Professional’s Alert: A twist on the general rule applies when you buy a capital asset on the last day of a month (regardless of the number of days in the month). To satisfy the long-term capital gain holding period, you must hold the asset until at least the first day of the 13<sup>th</sup> month following your purchase date. Therefore, if you bought stock on April 30, 2009 you have to hold it until at least May 1, 2010 for gain on its sale to be long-term capital gain.***

## II. Special holding periods

- A. There are a number of special holding periods that must be met for certain types of gains to be favorably taxed.
  - 1. If you inherit a capital asset, you automatically are treated as having held it for more than one year. For example, if you inherit a vacation home and sell it six months later at a gain, your gain is taxed at the long-term capital gains rate.
  - 2. A dual holding period applies if you have granted an incentive stock option (ISO) by your employer and you exercise the option and buy stock. To qualify for full long-term capital gain treatment on the stock you buy, you must hold the stock for 1) at least one year after the shares were transferred to you, and 2) at least two years from the date that the ISO was granted.
  - 3. Up to one-half of the gain on the sale of qualified small business stock is tax-free (and the balance is taxed at a special 28% capital gains rate) if the stock was originally issued after August 10, 1993 by a qualifying corporation, and the stock is held for more than five years.

***Tax Professional’s Alert: Refer to 2010 Tax Act for extension on Small Business stock sales.***

- 4. If you invest in commodity futures, gain on the sale of those futures qualifies as long-term capital gain as long as you held them for at least six months and a day before the sale.

5. A capital gain dividend from a mutual fund automatically is treated as long-term capital gain, regardless of how long you held the mutual fund shares generating the dividend.
6. Adding on someone else's holding period is available under the following circumstances:
  - a. Gifts include the donor's holding period and
  - b. Property acquired from your spouse (or your ex-spouse, in the case of a divorce).
7. Where you defer gain on property by exchanging it for other property, the holding period of the new property includes the holding period for the old property.

**Example:** If you swap an apartment building for an office building, your holding period for the office building includes the holding period of time you held the apartment building.

8. Assets, such as stocks or bonds owned by an IRA or a qualified retirement plan accounts do not qualify for long-term capital gain taxation. All withdrawals are treated as ordinary income.

#### **Chapter 4. Calculating Basis**

- I. In order to determine if you sold something at a taxable gain or deductible loss, you first have to compute its tax basis.
  - A. Basis is the tax system's way of measuring what you paid for your investment in stocks, bonds, or real estate.
  - B. Helping you to calculate your capital gains and capital losses, your basis is also used to figure deductions for depreciation, casualty losses, and charitable gifts.
- II. Basis on acquisition – Three basic types of basis are as follows:
  - A. Cost basis,
  - B. Fair-market value basis, and
  - C. Transferred basis.

**Example:** If you purchase 100 shares of the SBC Investor's Fund at \$40 per share, your cost basis is considered to be \$4,000, or \$40 per share. Suppose that this fund pays a dividend of \$2 per share (receiving \$200 for your 100 shares) and that you choose to reinvest this dividend to purchase more shares of the mutual fund. If, at the time of the dividend payment, the fund has increased to \$50 per share, your \$200 dividend purchases four more shares. Now you own 104 shares. At \$50 per share, your 104 shares are worth \$5,200. Your basis is your original investment of \$4,000 plus subsequent investments of \$200 for a total of \$4,200. If all shares sold for \$5,200 you would have a taxable profit of (\$5,200 less \$4,200) \$1,000.

III. Code sections and that determine basis:

Bought the property (or an applicable asset acquisition- Form 8594) – What did you pay?

- A. Section 1014 Inherited – Enter FMV (Fair Market Value) at decedent's death or alternative valuation six months later.
1. Your basis for figuring a gain or loss is usually the fair market value on the decedent's date of death.
  2. The executor of an estate is allowed to use an alternative valuation date, which is six months after the date of death.

***Tax Professional's Alert:*** *The six-month alternative valuation date can be utilized to save taxes when assets have gone down in value since the decedent's date of death.*

3. When you inherit something, the executor gives you the estate tax valuation.
4. When you sell the asset, that figure will be your tax basis.

***Tax Professional's Alert:*** *Look to the Form 706, U. S. Estate Tax Return for these values or when available, Form 8939 for step-up in basis of inherited property..*

- B. Section 1031 – Like-kind exchange – Form 8824.
- C. Section 1060 – Sale of business – applicable asset acquisition form.
- D. Section 1041 – Is used for divorce situation where property is divided.
1. Use your spouse's basis.
  2. Generally, neither spouse is required to pay tax on property transferred as part of a divorce settlement.

- E. Shareholder – S Corporation – must track basis from date acquired through each year until disposed.
- F. Partner’s basis – must track basis from date acquired through each year until disposed.

The two types of basis, which must be tracked in a Partnership

- 1. Inside Basis – representing the “ownership” in the assets of the Partnership.
- 2. Outside Basis – representing the “economic basis” in the Partnership for LOSS reporting purposes.

***Tax Professional’s: For the Shareholder in an S Corporation as well as a Partner in a Partnership, basis will be determined by how interest was acquired, such as gifts, inheritance, etc.***

IV. Property received as a gift:

- A. The basis in property received as a gift is:
  - 1. The adjusted basis to the donor just before it was given to you,
  - 2. Its FMV at the time it was given to you, and
  - 3. Any gift tax paid on it.
- B. If the FMV was less than the donor’s adjusted basis:
  - 1. Your basis for a gain is the same as the donor’s adjusted basis, increased by gift tax paid, and
  - 2. Your basis for a loss is its FMV at the time you received it, increased by any gift tax.

**Example:** Suppose your father gave you stock that cost him (basis) \$10,000, but was worth (FMV) \$8,000 when he gave it to you. If you sell the stock for \$12,000, you have a \$2,000 gain (sale price of stock \$12,000 - \$10,000 donor’s basis). If you sell the stock for \$7,000, you have a \$1,000 loss (sale price of stock \$7,000 - \$8,000 FMV). If the sale price is between the FMV and the donor’s cost (\$8,000 and \$10,000, in the example), you have neither a gain nor a loss. If your father paid gift tax when he gave you the gift, a portion of the gift tax that he paid is added to your basis.

- 3. If the FMV at the time of the gift was more than the donor’s basis, your basis for figuring the gain or loss was the donor’s basis.

**Example:** Suppose that your father gives you a gift of stock that cost him \$5,000 but was worth \$12,000 when he gave it to you. Your basis for figuring a gain or loss is \$5,000.

V. Section 83 – FMV of services rendered.

The amount that you are required to include in your income becomes your basis.

**Example:** You put the “deal” together and receive 100 shares of stock valued at \$10,000. Because you had to pay tax on the value of the shares you received, your tax basis for the 100 shares is \$10,000.

## Chapter 5. Definitions

I. Definitions are the spice of life for IRS agents.

- A. Most people refer to property as real estate.
- B. When the IRS talks about property, it could be anything that you own, such as a stock, bond, car, boat, or computer.
- C. When you see the term property on a form, the government is talking about more than the old “homestead”.
  - 1. Original Basis – Your investment in a property. For tax purposes, use the basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale or exchange of the property.
  - 2. Property purchased – Includes the amount you pay for it in cash, debt obligations, or other property or services.
  - 3. Cost includes:
    - a. Sales tax, and
    - b. Other expenses connected with the purchase.
  - 4. Adjusted Basis – Realizable basis in the asset as increased by the following the cost of improvements and reduced by such items as depreciation allowable, insurance reimbursements for casualty and theft losses and credits against cost, such as the new “employer provided child care facility”.

Other events that can require an adjustment to the basis are casualty losses for which you have claimed a tax deduction, or additions or improvements to the property.

***Tax Professional's Alert:*** *You will need to know your adjusted basis if you sell, trade or dispose of the asset, or suffer a casualty loss. Records for these items should be retained until you eventually dispose of the property.*

5. Tax Basis – The original cost you paid for an investment (plus expenses) that must be reported to the IRS when you sell the investment. The basis is used for calculating capital gains or losses.

**Example:** If you bought a stock for \$1,000 two years ago and sold it today for \$1,500, your income tax return would show a basis of \$1,000 and a taxable capital gains profit of \$500.

6. Depreciation – the cost of the asset spread over a number of years, deducting a part of the cost each year.

Depreciable property includes:

- a. Machinery,
- b. Equipment,
- c. Buildings,
- d. Vehicles, and
- e. Furniture.

Depreciable property does not include:

- a. Personal property such as a personal automobile.
- b. If the automobile is used both for business and personal purposes, only the business use portion may be depreciated.

Property may be depreciated if it meets all three of the following tests:

- a. It must be used in business or other income-producing activity,
- b. It must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes, and

- c. It must have a determinable useful life substantially beyond the tax year.

**Tax Professional's Alert: The various methods of applicable depreciation include:**

ACRS – the Accelerated Cost Recovery System.

MACRS – pronounced “makers”, property placed in service after 1986. The Modified Accelerated Cost Recovery System.

Pre-1981 depreciation – the same method used in the past.

Section 179 deduction – If you meet certain eligibility requirements, you can elect to deduct a limited amount (up to \$24,000 for 2001) of the cost of depreciable property in the year you buy it for use in your business.

- 7. Casualty loss deductions – subtracted from your adjusted tax basis in the property as of the year the loss occurred. Once you have a deductible casualty loss the following occurs:
  - a. The new basis in the property is used for depreciation purposes,
  - b. The tables can no longer be used to compute your depreciation expense, and
  - c. Actual formulas on which the depreciation tables are based are used.
- 8. Capital Asset Records – Accounting records that include the amount of accumulated depreciation claimed for each asset over the years, which enable the calculation of the adjusted basis.

**Tax Professional's Alert: These records should be retained as long as you own the asset.**

## **Chapter 6. Depreciation Methods**

- I. The rules and methods of depreciation vary.
  - A. The depreciation method that you use for any particular asset is fixed at the time you first place that asset into service.
  - B. Whatever rules or tables are in effect for that year must be followed as long as you own the property.

- C. Since Congress has changed the depreciation rules many times over the years, you may have to use a number of different depreciation methods if you have owned business property for a long time.
- D. If you own any business assets, you will need to keep track of their original basis (generally, this means the costs of acquiring each asset) and also any depreciation you have claimed over the years.
- E. This is necessary information to ascertain upon the sale if you have one of the following:
  - 1. A taxable gain,
  - 2. A loss, or
  - 3. A break-even.
- F. A record of accumulated depreciation should be started upon the acquisition of an asset to include:
  - 1. The acquisition date of the property,
  - 2. The anticipated depreciation deduction in each of the years over the useful life of the asset, and
  - 3. An accumulated depreciation calculation, which shows the cumulative depreciation to date.

***Tax Professional's: In this manner, you can see at a glance exactly how much depreciation you have claimed for that asset over the years, and you will know when the asset is fully depreciated so that no more deductions can be claimed.***

- G. For most business property placed in service after 1986, if you do not claim the equipment expensing deduction for the full cost of the item (Section 179), the IRS requires you to depreciate the asset using a method called "MACRS".

This method categories all business assets into classes and specifies the time period over which you can write off assets in each class.

- H. Some assets are not eligible for MACRS depreciation, including intangible assets such as:
  - 1. Patents,
  - 2. Trademarks, and

3. Business goodwill.
- I. Once the classification and the tax basis of the asset are determined, a special table provided by the IRS allows the calculation for the percentage of the assets tax basis that can be deducted each year.
1. MACRS provides for a slightly larger write-off in the earlier years of the cost recovery period.
    - a. The asset's tax basis does not change over the years.
    - b. Only the percentage used as a multiplier changes each year.
  2. If you do not use the asset 100 percent for business, then each year you must multiply the asset's total tax basis by the business percentage for that year, and then multiply the result by the fraction found in the table.

Some special variations of MACRS, or other depreciation methods, are available (or even mandatory) in certain situations, including:

- a. Assets of similar types may be grouped into general asset accounts,
- b. Variations on MACRS are available, for those who desire slower depreciation,

**Tax Professional's: This depreciation is mandatory for farm property and for 15 and 20-year property.**

- c. Straight-line depreciation is also available – mandatory for some alternative minimum tax purposes.
- d. Older methods of depreciation are used for pre – 1987 property.

### **Chapter 7. Disposing of Capital Assets**

- I. When you sell, scrap, or otherwise remove a capital asset from your business, you will have to report the change to the IRS and pay tax on any gain from the sale.
- A. The sale of Capital Assets is treated as:
1. Gains – Taxed at a lower rate than other income (pages 4 & 5 of text), or
  2. Loss - Deducted, may be limited.

- B. If you trade business property for other business property of the same asset class, you do not need to recognize a taxable gain or loss.
- C. Instead, you will be treated as making a nontaxable like-kind exchange, in which the tax basis of the old property becomes the tax basis of the new property.

**Example:** The most common situation in which this rule arises is when you trade in an old vehicle for a new one.

- D. When you dispose of a capital asset, your gain (or loss) is computed by subtracting your adjusted tax basis for the property from your net proceeds of the sale.
- E. Proceeds from the sale include the following:
  - 1. Cash you receive in the sale,
  - 2. The fair market value of any property or services you receive, and
  - 3. The value of any of your existing mortgage, loans and other debts that are assumed by the buyer.
- F. You may subtract any costs you incurred in the sale as follows:
  - 1. Broker's commissions,
  - 2. Advertising expenses,
  - 3. Appraisal fees,
  - 4. Legal fees,
  - 5. Surveys,
  - 6. Abstract and recording fees,
  - 7. Title insurance, and
  - 8. Transfer or stamp taxes.

***Tax Professional's Alert: Your adjusted tax basis is generally your original cost for the property, plus the cost of any improvements or additions, and minus any depreciation you claimed or casualty losses you have deducted.***

- G. In order to properly record and report a capital gain or loss on a sale of a capital asset a working knowledge is required including the following:

1. Special tax rates that apply to long-term capital gains,
2. How to calculate net capital gains, and how to deduct a loss,
3. How the recapture rules limit the application of capital gains tax breaks,
4. What happens in a foreclosure or involuntary conversion,
5. Installment sale rules that can save taxes in some situations,
6. Special rules for stock of qualified small business corporations, and
7. How to report sales of capital assets on a tax return.

**Tax Professional's Alert: Workpapers maintained by the tax professional should always substantiate basis and the calculation method.**