North Carolina Chapter NATP National Association of Tax Professionals

2023 Annual Conference
Tax Basis of Assets

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Objectives

- At the end of this course, you will be able to:
  - Identify items that increase and decrease basis
  - Categorize which costs can be deducted or capitalized
  - Recognize the impact of casualties and thefts
  - Evaluate the basis of property received for services
  - Calculate basis of inherited and gifted properties

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What is Basis?

- When property is acquired by any means, it is assigned a valued termed "basis," which represents the taxpayer's investment in the property.
- Basis is used to determine many of the tax-significant computations during the taxpayer's ownership of the property, including its final disposition.

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What is Basis?

- Property basis is usually its cost
- Original basis is adjusted by certain events
- The basis of some property cannot be determined by cost
- This webinar is divided into 3 sections
  - Cost Basis
  - Adjusted Basis
  - Basis Other Than Cost

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Cost Basis

Arizona Chapter 35 Years

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Cost Basis

- When property is purchased, basis includes:
  - Purchase price
  - Sales tax, freight, installation and testing
  - Excise taxes, revenue stamps, recording fees
  - Legal/accounting fees if they must be capitalized
  - Real estate taxes if assumed for the seller

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Loan with Inadequate Interest

- If property is purchased on a payment plan that charges little or no interest, the basis of the property is reduced by the amount considered to be unstated interest
- "Unstated interest" is generally any interest amount that is less than the applicable federal rate (AFR)
- IRS provides various prescribed rates for federal income tax purposes on a monthly basis. These rates, known as Applicable Federal Rates (AFRs), are regularly published as revenue rulings.

Real Property Basis

- Real property aka real estate is land plus anything built on or attached to it.
- Add to real property basis: abstract fees, charges for installing utility services, legal fees (including title search and preparation of contracts and deeds), recording fees, surveys, transfer taxes, title insurance.
- Also any amounts you pay for the seller, such as taxes, mortgage interest, charges for improvements or repairs, sales commission

Not Part of Real Property Basis

- Not includible in basis:
  - Casualty insurance premiums, rent for occupancy prior to closing, charges for utilities/services related to occupancy prior to closing
  - Any charges associated with getting a loan: mortgage insurance premiums, appraisal fees, credit report, loan assumption fees, points
- Some of these costs may be deductible, but they don't add to basis!

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Real Property Business Basis

- Deductible as business expenses:
  - Casualty insurance premiums
  - Rent for occupancy prior to closing
  - Charges for utilities and similar services related to occupancy
- Deducted over period of loan:
  - Charges connect with getting a loan (points, loan origination fee, mortgage insurance premiums, loan assumption fees, credit report fee, appraisal fee required by lender)
  - Refinancing fees

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Real Property Points

- Qualifying points paid to obtain a loan (mortgage, second mortgage, line of credit, home equity loan) are deducted over the term of the loan.
- Qualifying principal residence points paid in full are deductible in the year in which they are paid.

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Real Property Assumption of Mortgage

- Assumption of mortgage adds to property basis
  - John buys a building for $20,000 cash and assumes a mortgage of $70,000.
  - John's basis is $90,000.

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Construction Basis

- Part of basis:
  - Land, labor, materials, architect's fees, building permit charges, payments to workers/contractors, equipment rental fees, inspection fees
- Not part of basis:
  - Value of unpaid labor and free materials

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UNICAP

- The UNICAP (or uniform capitalization) rules require the capitalization of direct and indirect costs to real and tangible personal property produced by the taxpayer and real and personal property acquired by the taxpayer for resale.
- The rules apply to taxpayers who produce real or tangible personal property for use in business; produce real or tangible personal property for sale to customers; acquire property for resale.

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UNICAP Rules

- Under these rules, the taxpayer must capitalize all direct costs and a portion of indirect costs incurred for the property.
- **Direct costs** include direct material costs and direct labor costs (labor includes full-time and part-time employees, as well as contract employees and independent contractors and, overtime pay, vacation pay, payroll taxes, among other items).
- **Indirect costs** include such things as indirect labor costs, employee benefit expenses, indirect material costs, purchasing costs, handling costs, storage costs, rent, taxes, insurance, utilities, engineering and design costs, tools and equipment, bidding costs, interest, and licensing and franchise costs.

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UNICAP Rules

- That's an awful lot of bookkeeping effort!
- Yes…but there are a many exceptions to the UNICAP requirement, so chances are that your clients aren't affected!

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UNICAP Exceptions

- Beginning in 2018, taxpayers could avoid the UNICAP requirements if their average annual gross receipts were $25M or less for the preceding tax years ($27M for 2022, $29M for 2023)
- Also not subject to the UNICAP rules:
  - Property produced not used in trade, business or profit activity
  - Qualified creative expenses incurred as a freelance writer, photographer, or artist
  - Research and experimental expenses deductible under §174
  - (There are many more…)

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Capitalization vs Depreciation

- Related concepts!
- Capitalization moves an expense from the income statement to the balance sheet
- Depreciation gradually moves it back to the income statement

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Deducting vs Capitalizing

- No double dipping!
- If you deducted it, don't capitalize it.
- If you capitalized it, don't deduct it.

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Can be Deducted OR Capitalized

- Carrying charges, such as interest and taxes, paid to own property
- Research and experimental costs
- Intangible drilling/development costs for oil, gas and geothermal wells
- Exploration costs for new mineral deposits
- Costs of removing architectural and transportation barriers (subtract amount of credit)
- Costs of establishing, maintaining or increasing the circulation of newspaper/periodical

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Intangible Assets

- Intangibles such as goodwill, patents, copyrights, trademarks, trade names and franchises have basis, usually the purchase price or cost to create.
- Self-created intangibles have zero basis.
- Basis of franchise is usually just its cost, unless the payments are deducted as a business expense.

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Patent Basis

- Basis of a patent is usually cost of research, experimental expenditures, drawings, working models, fees for attorneys and applying for the patent.
- (If any expenditure is deducted, then it does not become part of basis)..
- Inventor’s time is **not** part of basis.

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Copyright Basis

- For authors, the basis of a copyright includes copyright fees, attorneys' fees, clerical help
- Does not include anything the author did not pay for, such as their own time or that of unpaid labor

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Basis of Stocks & Bonds

- Basis of stocks is the purchase price, plus costs of purchase such as commissions, for each individual tax lot.
- Stock basis changes as a result of occurrences such as splits and reverse splits.
- Stocks purchased via dividend reinvestment plans have a basis equal to the taxable dividend.
- Basis of a bond is its purchase price plus costs of purchase.

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Basis of Digital Assets

- Basis of digital assets depends on how the asset in question was acquired.
  - Basis of a mined asset is equal to the FMV at the date/time of receipt.
  - Basis of a purchased or traded asset is equal to the FMV at date/time of receipt plus any fees paid.
  - Basis of an asset received in exchange for goods/services is equal to the FMV at the date/time of receipt.
  - Basis of an asset received via a fork or airdrop is equal to the FMV at the date/time of receipt.

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Basis of Digital Assets (cont.)

- Basis of digital assets such as NFTs also depend on how the asset was acquired.
  - If the NFT was purchased, acquired by trade, or received in exchange for goods/services, then its basis is equal to the FMV at date/time of receipt plus any fees paid.
  - If an NFT is created by the taxpayer (such as digital art) its basis is equal to the cost of creation – possibly software and hardware, if that cost can be allocated to that particular NFT. The creator will also add gas and auction fees to basis upon sale.

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Allocating Basis

- If the taxpayer acquires a trade or business, §1060 governs how purchase price is allocated..
- Purchase price is allocated to each asset.
  - Purchase price is first assigned to the **most liquid** and **easiest to value.**
  - Last amount of purchase price is assigned to least liquid and hardest to value.
- §1060 **requires** the buyer and seller to agree on the allocation of purchase price for an asset sale transaction.
- If that doesn't happen, then purchase price is allocated to the assets involved using the residual allocation method.

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Seven Asset Classes

- Assets are divided into seven asset classes
- Class I: Cash (probably not part of a business sale)
- Class II: Actively traded personal property, CDs, foreign currency
- Class III: Marked to market assets and debt instruments, also A/Rs
- Class IV: Inventory
- Class V: Anything that doesn't fall into another class
- Class VI: §197 intangibles, including non-compete agreements, other than goodwill and going concern
- Class VII: Goodwill and going concern (value attributed to workforce in place, business books and records, operating systems, etc.)

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Seven Asset Classes

- Assets in Class 1 are allocated dollar for dollar
- The remaining purchase price is then reduced by the FMV of the assets in Class II
- Then that remaining purchase price is reduced by the FMV of the assets in Class III, then Class IV, etc.
- Anything remaining is allocated to Class VII

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Form 8594, *Asset Acquisition Statement*

Form **8594** (Rev. November 2021) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

► Attach to your income tax return.

► Go to *www.irs.gov/Form8594* for instructions and the latest information.

OMB No. 1545-0074

Attachment Sequence No. **169**

Name as shown on return | Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction | Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale | 3 Total sales price (consideration)

Must be filed by both buyer and seller, attached to the business tax return when there is a transfer of a group of assets that makes up a trade or business and the purchaser's basis in those assets is determined wholly by the amount paid for the assets.

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Form 8594, *Asset Acquisition Statement*

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Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . ☐ Yes ☐ No

Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document?

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Asset Sale Example

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- IMHO Corp sold all its business assets to LOL Corp for $199,000
- Sold assets are:
  - Inventory FMV $1,000
  - Building FMV $130,000
  - Land FMV $10,000
  - Equipment FMV $8,000
  - Remaining $50,000 is assigned to goodwill

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Demolition Costs

- Demo costs are added to the basis of the land, not deducted
- Modification is not considered demolition if:
  - 75% or more of existing external walls are retained as either external or internal walls
  - 75% of more of existing internal structural framework of the building is retained in place
  - If the building is a certified historic structure, the modifications must be part of a certified rehabilitation
  - In such cases, the costs of modification are added to building basis

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Subdivided Lots

- If a taxpayer buys and subdivides a tract of land, the basis of each lot must be determined and the full cost of the land is not recovered until all lots are sold.

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Cost Basis Example

- Alice buys a tract of land and calculates the cost basis of the tract to be $15,000.
- Alice divides the tract into 15 lots of equal size and assigns a land basis of $1,000 to each lot.

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Correcting Erroneous Cost Basis

- If a taxpayer makes an error in figuring cost basis of subdivided lots sold in previous years, the taxpayer cannot correct the error for years in which the statute of limitations (typically 3 years) has expired.
- However, the taxpayer may change the basis of the remaining lots.

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Correcting Erroneous Cost Basis Example

- Alice buys a tract of land and calculates the cost basis of the tract to be $15,000, divides the tract into 15 lots of equal size and assigns a land basis of $1,000 to each lot
- Some years later, Alice realizes that the original basis was actually $22,500, so each lot would have a basis of $1,500.
  - But 8 lots have already been sold and the statute of limitations has passed!
- Alice can't correct the basis of lots already sold, but she can use the $1,500 basis for remaining lots.

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QUIZ

- Which settlement costs cannot be included in cost basis when purchasing real estate?

a. Charges for installing utility services
b. Legal fees
c. Costs of getting a mortgage
d. Recording fees

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Adjusted Basis

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Stuff Happens

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- Own a property for long enough, stuff happens…
  - Improvements
  - Depreciation
  - Casualties and thefts
  - Tax credits
  - Legal fees
- And all the stuff that happens affects basis!

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What is Adjusted Basis?

- Original basis
- \+ Some things
- – Other things
- = Adjusted Basis

Things That Increase Basis

- Capital Improvements: additions, new roofs, new A/C, paving a driveway, replumbing or rewiring
- Assessments for Improvements: water connections, sidewalks, roads
- Casualty losses
- Legal fees: cost of defending a title, a property line
- Zoning costs
- Rehabilitation costs less credits

Things That Decrease Basis

- Energy credits
- Casualty/theft loss deductions and insurance reimbursements
- Vehicle credits
- Depreciation of all types
- Postponed gain
- Easements

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Casualties and Thefts

- Basis is increased by amounts spent on improvements that substantially prolong the life of the property, increase its value, or adapt it to a different use (otherwise, it's a repair).
- Basis is decreased by insurance or any other reimbursement.
- Basis is decreased by deductible loss not covered by insurance.

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Easements

- Amounts received for granting an easement are considered a sale of property
- Reduces the basis of that part of the affected property
- If amount received is more than the basis of that part of the property's basis, then basis is reduced to zero and the excess is treated as a (taxable) gain

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Easement Example

- Dan granted his neighbor, Ellen, an easement on his own property so Ellen could more easily access her own property.
- Ellen paid Dan $1,000 to grant that easement
- That isn't taxable income to Dan, but he must reduce his property basis by that $1,000

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Depreciation

- Basis is decreased by any depreciation that **was** deducted (include special, bonus and §179) or **could have been** deducted.
- If taxpayer took less depreciation than they could have, basis is decreased by the amount that could have been taken.
- If taxpayer took NO depreciation, basis is decreased by the amount that **could** have been taken.
- If taxpayer took more depreciation than they should have, reduce basis by the full amount that was taken.

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Depreciation On a Business Vehicle

- If accelerated depreciation was taken on a business vehicle and usage subsequently drops below 50%:
  - Discontinue accelerated depreciation
  - Begin straight-line depreciation
  - Recompute excess depreciation (amount of accelerated over SL) in prior years
  - Report that excess amount as ordinary income
  - Add that excess amount to vehicle basis

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Form 3115

- Form 3115, *Application for Change in Accounting Method*, is used to correct most other depreciation errors, including the omission of depreciation.
- If you forget to take depreciation on an asset, the IRS treats this as the adoption of an incorrect method of accounting, which may only be corrected by filing Form 3115.
- Changes that are considered to be a change in accounting method are changing from not taking depreciation to taking depreciation, changes in methods or conventions, changes to or from a required life, correcting depreciation on leasehold improvements from using the incorrect life of the lease term to the correct life of the asset.

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Depreciation and §179

- If a property is completely depreciated or the full value of the property has been deducted via §179, then the basis of that property is $0.
  - Unless there is a subsequent addition to basis!
  - Example: taxpayer takes a full §179 deduction for a business vehicle, but later pays $1,000 for new upholstery.
  - That $1,000 may be deducted or added to the vehicle's basis.

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Vehicle Credits

- Bases of qualified vehicles are reduced by amounts claimed via the qualified electric vehicle credit, alternative motor vehicle credit, drive motor vehicle credit, clean vehicle credit and any other such credits!
- If no credit is claimed, no basis reduction is required.

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Solar Energy Credits

- Credits come and go…
- But tax treatment remains constant
- Increase basis by the amount paid for the solar panels and other equipment
- Decrease basis by the amount of the credit

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Solar Energy Credit Example

- Bob has qualifying solar equipment installed.
- Total cost of the solar equipment including sales tax and installation is $30,000.
- Basis of the property affected increases by that $30,000.
- He receives a federal tax credit of $9,000.
- He also receives a state tax credit of $1,000.

What's the basis of the property now?

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Postponed Gain from Sale of Home

- Back in 1997, we didn't have the §121 exclusion
- Instead, we have a rule that said gain was postponed if:
  - 1) You buy and live in a new main home within the replacement period.
  - 2) The new main home costs at least as much as the adjusted sales price of the old home.
- From Pub 523, 1997 version: "The tax on the gain is postponed, not forgiven. You subtract any gain that is not taxed in the year you sell your old home from the cost of your new home. This gives you a lower basis in the new home."

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Postponed Gain from Sale of Home

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- Jack sold his home in January 1997 for $90,000 and had a $5,000 gain. Within the time allowed for replacement, Jack bought another home for $103,000 and moved into it.
- The $5,000 gain will not be taxed in 1997, but Jack must subtract it from the $103,000 basis of the new home.
- Jack later sells the new home for $110,000.
- He has gain of $110,000 - $98,000 = $12,000.

Can Jack use the §121 exclusion on that $12,000 of gain?

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Disposition of MACRS Property

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- If the taxpayer sells a portion of a MACRS asset, the adjusted basis of the MACRS asset must be reduced by the adjusted basis of the portion sold.
- If the taxpayer physically abandons a portion of a MACRS asset and elects to recognize the loss on the tax return, the adjusted basis of the MACRS asset must be reduced by the adjusted basis of the abandoned portion.

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Joe’s Property

- Joe paid $80,000 for real property (land and a building) in 2017, as well as commissions of $2,000 and legal fees of $600.
- Total basis of $82,600 is allocated as follows: land $10,325 and building $72,275.
- Joe then spent $20,000 remodeling the building before placing it in service.
- Joe took depreciation of $14,526 for 2017-2021.
- Joe had a $5,000 casualty loss that was not covered by insurance; he took a deduction for it.
- He spent $5,500 repairing the damage, which extended the useful life of the building.

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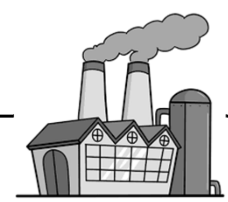
Joe’s Property (cont.)



• Joe’s basis as of 1/1/2022 is:	
• Building basis including fees:	$72,275
• Improvements	$20,000
• Repair of damages	$ 5,500
• Subtotal	$97,775
• Less depreciation	($14,526)
• Less deducted loss	($5,000)
• Adj basis	($78,249)

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Barb’s Building

- Barb purchased a building to use in her business in 1995 for $75,000.
- It’s a MACRS asset.
- She removed (and thus abandoned) the roof and replaced it with a new roof in 2021.
- She makes the partial disposition election to recognize the loss on the abandonment of the old roof by reporting it on her tax return.
- The amount of her loss is the adjusted basis of the roof as of Jan 1, 2021.
- Barb determines that the unadjusted basis of the roof is $5,000 and $3,500 of depreciation was taken on it; adjusted basis is $1,500.

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Barb’s Building

- She reports the loss of $1,500 as an ordinary loss on Part II of Form 4797.
- The unadjusted basis of the remaining building is reduced by $5,000 and the accumulated depreciation of the building is reduced by the depreciation allocable to the roof, $3,500.
- The new roof is listed as a separate asset on the depreciation schedule.

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Edward's Excavator

- Edward purchased an excavator in 2019 for $25,000 for use in his landscaping business.
- It's a MACRS asset.
- Edward replaced the excavator's bucket with a new one in 2022.
- He determined that the old buckets had an unadjusted basis of $5,000 and he had taken depreciation of $3,800, resulting in an adjusted basis of $1,200.
- The amount of his loss is the adjusted basis of the bucket as of Jan 1, 2022.

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Edward's Excavator

- Edward made the partial disposition election to recognize the loss of the original bucket and reported the $1,200 loss on his tax return.
- He must reduce the unadjusted basis of the excavator by the unadjusted basis of the bucket, $5,000 and reduce the accumulated depreciation by the depreciation taken on the bucket, $3,800.
- The new bucket must then be capitalized as a separate asset.

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QUIZ

- Which of the following **cannot** add to basis?

a. Carrying charges such as interest and taxes
b. Costs you deduct in the tax year
c. Research and experimental costs
d. Costs of removing architectural and transportation barriers

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Basis Other Than Cost

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Assets Aren't Always Purchased!

- Property received for services
- Taxable and nontaxable exchanges
- Property transferred from spouse
- Gifted property
- Inherited property
- Property changed to business or rental use

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Fair Market Value – What It Isn't

- It isn't what you paid for an item (probably too much).
- It isn't wishful thinking (also probably too much).
- It isn't family lore (again, probably too much).
- It isn't outdated appraisal values (too much or too little).
- It isn't what you think it should be (nor the amount of money needed to pay bills).
- It isn't the asking price you see on a similar item on the internet or Ebay (asking and getting are different things).
- It isn't based on sentimentality (how much Grandma cherished it).
- It isn't about how old it is ("old" doesn't necessarily = valuable).

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Fair Market Value – What It Is

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- Fair market value (FMV) is defined as the price at which property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

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Property Received for Services

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- If property is received for services, that property's FMV is included in the taxpayer's income.
- That amount you paid tax on is now the basis of that property.
- If the value of the services performed were agreed upon beforehand, this value is accepted as the FMV of the property if there's nothing weird going on.
- (The IRS doesn't like shenanigans.)

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Received for Services Example #1

- Charlene agrees to do Dan’s tax return in exchange for an area rug that she admired in his office.
- The FMV of the rug is $500.
- Charlene will include $500 in her business income; this is the basis of the rug moving forward.
- It’s included in business income because she’s exchanging business services for the property.

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Received for Services Example #2

- Ellen agrees to watch Harry’s kids for a weekend in exchange for an area rug that she admired at his home.
- This is not what Ellen does for a living.
- The FMV of the rug is $500.

Does anything get reported on Ellen’s tax return?

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Nontaxable Involuntary Conversion

- A §1033 exchange is an exchange that benefits real estate owners who involuntarily convert their property into cash and experience taxable gains.
- Like a §1031 exchange a §1033 exchange requires reinvestment of proceeds into like-kind real estate to gain the benefits of the exchange.
- However, a §1033 does not have the same strict timing requirements as a § 1031.

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Involuntary Conversion

- Four types of involuntary conversion recognized by the tax code:
  - Property destroyed by fire, weather or some other hazard
  - Property stolen
  - Property taken by the government for public use, known as "condemned property"
  - Property disposed of under the threat of condemnation
- Involuntary conversions are also called involuntary exchanges.

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Involuntary *Conversion*

- Receiving money or property as compensation for the loss is what makes a property a "conversion." This includes things such as:
  - An insurance settlement
  - A court judgment or a payment from the government that condemns a property

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Bob's Property

- Bob's property was condemned; adjusted basis is $20,00.
- Bob was paid $25,000 for it, so he has a **realized** gain of $5,000.
- Bob bought replacement property similar in use to the condemned property for $23,000.
- Bob has a **recognized** gain of $2,000 (unspent monies from the $25,000) and unrecognized gain of $3,000.
- Adj basis of Bob's new property: $23,000 - $3,000 = $20,000.

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Property Transferred From a Spouse

- Basis of property transferred to a spouse, whether in trust for your benefit or incident to divorce) retains the other spouse's adjusted basis.
- If property transferred is a series E, EE or I U.S. savings bond, the transferor must include in income the interest accrued to the date of transfer.
- The recipient's basis is equal to the resulting basis of the transferor (i.e., it includes the interest because it was included in income).

Does basis get stepped-up when an asset is transferred incident to divorce?

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Gifted Property

- Basis of gifted property is either going to be the adjusted basis in the hands of the giver OR the property's FMV at the time of the gift.
- It just depends on the circumstances!

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FMV Lower Than Adj Basis

- If the FMV of the property is less than the giver's adjusted basis, the receiver's basis depends on whether he has a gain or a loss upon disposition.
  - Basis for figuring gain is the same as the giver's adjusted basis, plus or minus any adjustments required.
  - Basis for figuring loss is the FMV, plus or minus any adjustments required.
  - If the sale price is in between the giver's adjusted basis and the FMV, there is neither a gain nor a loss recognized.

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FMV Higher Than Adj Basis

- If the FMV of the property at the time of the gifting was more than the giver's adjusted basis, then the receiver's basis is the donor's adjusted basis, increased by any gift tax paid.

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Gifted Basis Example

- Don received land from his father as a gift. The land had a FMV of $8,000, and Dad's adjusted basis was $10,000.
- Don later sold the land for $12,000 and recognized a $2,000 gain.
- If Don had later sold the land for $7,000, he would recognize a $1,000 loss.

If Don had sold the land for $9,000, what would his gain or loss be?

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Depreciating Gifted Property

- If the receiver is using the gifted property in business, basis for calculating depreciation, amortization, depletion, etc. is the donor's adjusted basis, plus or minus any required adjustments while property was held.

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Impact of Gift Tax Paid

- The impact of gift tax depends on whether the gift was made before or after 1977.
- Before 1977, full amount of the gift tax is added to donor's adjusted basis to arrive at receiver's basis, but NOT TO EXCEED the FMV.
- The full amount of the gift tax is NOT added to giver's adjusted basis if the gift was given after 1976.
- Instead, we calculate the amount of the gift tax attributable to the increase in value of the gift.

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Gift Before 1977

- Cindy was given a home by her mom in 1976.
- FMV was $21,000, Mom's adjusted basis was $19,000.
- Mom paid gift tax of $1,000.
- Cindy's basis is $20,000.

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Gift After 1976

- Debbie was given a home by her mother in 1977. FMV was $50,000, Mom's adjusted basis was $20,000. She paid gift tax of $7,100 on $35,000 of gift ($50,000 minus exclusion of $15,000). We calculate Debbie's basis as follows:
  - FMV = $50,000
  - Increase in value is the difference between Mom's adjusted basis and the FMV, which is $50,000 - $20,000 = $30,000.
  - Increase in value divided by the gift amount is $30,000 ÷ $35,000 = .86
  - Multiply gift tax by .86 = $6,106
  - This is added to the adjusted basis, so Debbie's basis is $20,000 + $6,106 = $26,106

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Inherited Property

- Adjusted basis of inherited property is one of the following:
  - FMV on date of death
  - FMV on alternate valuation date
  - Value under special-use evaluation method for real property used in farming or a closely held business
  - Decedent's adjusted basis in the land to the extent of the value excluded from the decedent's estate as a qualified conservation easement.
- If estate return not filed, then basis is its appraised value at the date of death.

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What Doesn't Count as Inherited Property?

- Appreciated property given by the heir to the decedent within one year prior to the decedent's death.
- In that case, the heir's basis is the same as the decedent's adjusted basis just prior to his death, not the FMV.
- Appreciated property in this circumstance is defined as any property with a FMV greater than the adjusted basis of the giver on the date the gift was made.

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Inheritance in Community Property States

- In community property states, married persons are considered to each own half of the community property.
- In these states, when either spouse dies, the basis of the entire property is stepped up to the FMV.
- This rule is contingent upon at least half the value of the community property being included in the decedent's gross estate, regardless of an estate return being filed.

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Property Changed to Business Use

- If property is held for personal use and then changed to business (or rental) use, the basis for depreciation is the lesser of the FMV of the property OR the taxpayer's adjusted basis at the time of the change.
- Yvonne decides to turn her personal residence into a rental.
  - Residence has an adjusted basis of $178,000 + $25,000 for the land = $203,000.
  - FMV for both house and land was $165,000 + $15,000 for the land = $180,000.
  - Her basis for depreciation is $165,000.

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Questions?

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