Department
of the
Treasury

**Internal
Revenue
Service**

Publication 551
(Rev. Dec.95)
Cat. No. 15094C

Basis of Assets

Introduction

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure the deductions for depreciation, amortization, depletion, and casualty losses. Also use it to figure gain or loss on the sale or other disposition of property. You must keep accurate records of all items that affect the basis of property so you can make these computations.

This publication is divided into three sections:

- Cost Basis,
- Adjusted Basis, and
- Other Basis.

The basis of property you buy is usually its cost. In addition, if you use the asset in a trade or business or an activity conducted for profit, capitalize (add to basis) many direct and indirect costs.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, reduce your basis.

You cannot determine your basis in some assets by cost. This includes property you receive as a gift or inheritance. It also applies to property received in an involuntary exchange, and certain other circumstances.

Useful Items

You may want to see:

Publication

- ☐ **448** Federal Estate and Gift Taxes
- ☐ **525** Taxable and Nontaxable Income
- ☐ **535** Business Expenses
- ☐ **544** Sales and Other Dispositions of Assets
- ☐ **917** Business Use of a Car
- ☐ **946** How To Depreciate Property

Form (and Instructions)

- ☐ **706–A** United States Additional Estate Tax Return
- ☐ **8594** Asset Acquisition Statement

Ordering publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). Or, you can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

Telephone help. You can call the IRS with your tax questions Monday through Friday during regular business hours. Check your telephone book for the local number or you can call **1–800–829–1040.**

Telephone help for the hearing-impaired persons. If you have access to TDD equipment, you can call **1–800–829–4059** with your tax question or to order forms and publications. See your tax package for the hours of operation.

Cost Basis

Terms you may need to know (see Glossary):

Business assets
Goodwill
Nonbusiness assets
Real property
Unstated interest

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, or in other property. Your cost also includes amounts you pay for:

1) Sales tax charged on the purchase,
2) Freight charges to obtain the property,
3) Installation and testing charges,
4) Excise taxes,
5) Legal and accounting fees (when they must be capitalized),
6) Revenue stamps,
7) Recording fees, and
8) Real estate taxes (if assumed for the seller).

In addition, the basis of real property and business assets may include other items.

Loans with low or no interest. If you buy business or investment property on any time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, less the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate. See the discussion of unstated interest in Publication 537, *Installment Sales.*

Purchase of a business. When you purchase a trade or business, you generally purchase all assets used in the business operations, such as land, buildings, and machinery. You must spread the price among the various assets including any section 197 intangibles, such as goodwill. See *Allocating the Basis,* later.

Stocks and Bonds

The basis of stocks or bonds is the purchase price plus any costs of purchase such as any commissions and recording or transfer fees.

If you acquired stock through an automatic investment program, dividend reinvestment plan, or by exercising stock rights, see *Stocks and Bonds* in chapter 4 of Publication 550, *Investment Income and Expenses* for information on basis.

Mutual fund shares. If you sell or exchange mutual fund shares, you may use an average basis if:

1) You acquired the shares at different times and prices, and
2) You left the shares on deposit in an account kept by a custodian or agent.

For more information, see *Average Basis* in Publication 564, *Mutual Fund Distributions.*

Real Property

If you buy real property, certain fees and other expenses you pay are part of basis in the property.

Real estate taxes. If you buy real property and agree to pay certain taxes the seller owed on it, treat the taxes you pay as part of your basis. You cannot deduct them as taxes.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount. Do not include that amount in the basis of the property.

Settlement costs. You can include in the basis of property you purchase the settlement fees and closing costs that are for buying it. You cannot include the fees and costs that are for getting a loan on the property. (A fee is for buying property if you would have had to pay it even if you bought the property for cash.)

Some of the settlement fees or closing costs that you can include in the basis of your property are:

1) Abstract fees (sometimes called abstract of title fees),
2) Charges for installing utility services,
3) Legal fees (including title search and preparing the sales contract and deed),
4) Recording fees,
5) Surveys,
6) Transfer taxes,
7) Title insurance, and
8) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

You must reasonably allocate these fees or costs between land and improvements, such as buildings, to figure the basis for depreciation of the improvements. Allocate the fees according to the fair market values of the land and improvements at the time of purchase.

Settlement costs ***do not include*** amounts placed in escrow for the future payment of items such as taxes and insurance.

Some settlement fees and closing costs you ***cannot*** include in the basis of the property are:

1) Fire insurance premiums.
2) Rent for occupancy of the property before closing.
3) Charges for utilities or other services relating to occupancy of the property before closing.
4) Charges connected with getting a loan, such as:
   a) Points (discount points, loan origination fees),
   b) Mortgage insurance premiums,
   c) Loan assumption fees,
   d) Cost of a credit report, and
   e) Fees for an appraisal required by a lender.
5) Fees for refinancing a mortgage.

Points. If you pay points to obtain a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), you generally must capitalize and amortize them ratably over the term of the loan. Do not add the cost to the basis of the related property.

Points on home mortgage. Special rules may apply to the amounts you and the seller pay as points when you obtain a mortgage to purchase your main home. If these amounts meet certain requirements, you can deduct it in full as points for the year in which they are paid. If you deduct seller-paid points, reduce your basis by that amount. For more information, see *Points* in Publication 936, *Home Mortgage Interest Deduction.*

Assumption of mortgage. If you buy property and assume an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage you assume.

Example. If you buy a building for $20,000 and assume a mortgage of $80,000 on it, your basis is $100,000.

Constructing nonbusiness assets. If you build nonbusiness property (i.e., a home) or have assets built for you, the expenses you pay for this construction are part of your basis. Some of these expenses include:

Land,
Materials and supplies,
Architects' fees,
Building permits,
Payments to contractors,
Payments for rental equipment, and
Inspection fees.

In addition, if you own a business and use your employees, material, and equipment to construct a nonbusiness asset, your basis would also include:

1) Employee compensation paid for the construction work,
2) Depreciation on your equipment while it is used in the construction,
3) Operating and maintenance costs for equipment used in the construction, and
4) The cost of business supplies and materials used in the construction.

Do not deduct these expenses, which you must capitalize (include in the asset's basis).

Also, reduce your basis by any jobs credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in 1). Do not include the value of your own labor, or any other labor you did not pay for, in the basis of any property you construct.

Business Assets

Terms you may need to know (see Glossary):

Amortization
Capital assets
Capital expenses
Capitalization
Depletion
Depreciation
Goodwill
Intangible property
Personal property
Recapture
Section 179 deduction
Tangible property

If you purchase property to use in your business, your basis is usually its actual cost to you. However, if you construct, build, or otherwise produce property, you may be subject to the uniform capitalization rules (discussed later) to determine the basis of the property.

Example 1. Dale White is an independent contractor. He purchased a building for his business. He used it to store his construction equipment. His basis in the building is its cost to him.

Example 2. Assume the same facts as in Example 1 except, instead of purchasing the building, Dale had his employees construct the building. He must determine his basis in the building under the uniform capitalization rules.

Example 3. Dale also had his employees build a home for his personal use. His basis in the house is explained earlier under *Constructing nonbusiness assets.*

Example 4. Assume the same facts as in Example 3 except Dale sold the house without ever using it as a personal residence. He must determine his basis in the house under the uniform capitalization rules.

Uniform Capitalization Rules

The uniform capitalization rules specify the costs you add to basis in certain circumstances.

Who must use. You must use the uniform capitalization rules if you:

1) Produce real property or tangible personal property for use in a trade or business or an activity engaged in for profit,
2) Produce real property or tangible personal property for sale to customers, or
3) Acquire property for resale.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise or grow the property. Treat the property produced for you under a contract as produced by you up to the amount you pay or costs you otherwise incur for the property. Tangible personal property includes films, sound recordings, video tapes, books, or similar property.

Under the uniform capitalization rules, generally you must capitalize direct costs and an allocable part of most indirect costs incurred due to production or resale activities. You must include certain expenses you have during the year in the basis of property you produce or in your inventory costs, rather than deduct them as a current expense. You recover these costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Any cost that you could not use to figure your taxable income for any tax year is not subject to the uniform capitalization rules.

Exceptions. The uniform capitalization rules do not apply to certain property. This includes:

1) Property you produce that you do not use in your trade, business, or activity conducted for profit.
2) Costs paid or incurred by an individual (other than as an employee) or a qualified employee-owner of a corporation who is a writer, photographer, or artist.
3) Property you produce under a long-term contract.
4) Research and developmental expenses allowable as a deduction under section 174 of the Internal Revenue Code.
5) Costs for personal property acquired for resale if your (or your predecessor's) average annual gross receipts do not exceed $10 million.

Special rules apply to costs incurred in the business of farming, see chapter 7 of Publication 225.

For more information on the uniform capitalization rules, see the regulations under section 263A of the Internal Revenue Code.

Intangible Assets

Intangible assets include goodwill, patents, copyrights, trademarks, trade names, and franchises. The basis of an intangible asset is usually its cost. If you acquire multiple assets, for example a going business for a lump-sum. see *Allocating the Basis,* later, to figure the basis of the individual assets. The basis of certain intangibles can be amortized, see chapter 12 of Publication 535.

Patents. The basis of a patent you get for your invention is the cost of development, such as research and experimental expenditures, drawings, working models, and attorneys' and governmental fees. If you deduct the research and experimental expenditures as current business expenses, you cannot include them in the basis of the patent. The value of the inventor's time spent on an invention is not part of the basis.

Copyrights. If you are an author, the basis of the copyright for your work usually will be your cost of getting the copyright plus copyright fees, attorneys' fees, clerical assistance, and the cost of plates that remain in your possession. Do not include in the basis the value of your time as the author, or any other person's time you did not pay for.

Franchises, trademarks, and trade names. If you buy a franchise, trademark, or trade name, the basis is its cost, unless you can deduct your payments as a business expense.

Allocating the Basis

If you buy multiple assets for a lump sum, allocate the amount you pay to each of the assets you receive. Make this allocation to figure your basis for depreciation and gain or loss on a later disposition of any of these assets. See *Trade or Business Acquired,* later.

Group of Assets Acquired

If you buy multiple assets for a lump sum, you and the seller may agree to a specific allocation of the purchase price to each asset in the sales contract. If this allocation is based on the value of each asset and you and the seller have adverse tax interests, the allocation generally will be accepted. However, see *Trade or Business Acquired,* next.

Trade or Business Acquired

If you acquire a group of assets that is a trade or business, allocate the purchase price to the various assets acquired.

Make the allocation among the assets in proportion to (but not in excess of) their fair market value on the purchase date in the following order:

1) Cash, demand deposits, and similar accounts, and then
2) Certificates of deposit, U.S. Government securities, readily marketable stock or securities, and foreign currency,
3) All other assets except section 197 intangibles, and
4) Section 197 intangibles.

Agreement. If you and the seller agree in writing to allocate the consideration, or the FMV of any asset, the agreement is binding on both you and the seller unless the IRS determines that the amounts are not appropriate.

Reporting requirement. Both the buyer and seller of a trade or business must report to the IRS the allocation of the sales price among section 197 intangibles and the other business assets. Use Form 8594, to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax returns for the year in which the sale occurred.

Land and Buildings

If you buy buildings and the land on which they stand for your business and you pay a lump sum for it, allocate the basis of the whole property among the land and buildings so you can figure the depreciation allowable on the buildings.

When you allocate the basis between land and buildings, the amount used as the basis of each asset is the ratio of the FMV of that asset to the FMV of the whole property at the time you get it. If you are not certain of the FMV of land and buildings, you may allocate the basis among them based on their assessed values for real estate tax purposes.

Demolition of building. Add demolition costs and other losses incurred for the demolition of any building to the basis of the land on which the demolished building was located. Do not claim it as a current deduction.

Modification of building. A modification of a building will not be treated as a demolition if:

1) 75 percent or more of the existing external walls of the building are retained in place as internal or external walls, and
2) 75 percent or more of the existing internal structural framework of the building is retained in place.

If the building is a ***certified historic structure*** the modification must be part of a certified rehabilitation. If these conditions are met, add the costs of the modifications to the basis of the building.

Subdivided lots. If you buy a tract of land and subdivide it, allocate the basis to the individual lots based on the FMV of each lot to the total price paid for the tract. This allocation is necessary because you must figure the gain or loss on the sale of each individual lot. As a result, you do not recover your entire cost in the tract until you have sold all of the lots.

Future development costs. Certain procedures explain how to get permission to add to the basis of each lot the estimated future cost of qualified development expenses.

For sales you made after December 31, 1992, of lots on which development work is not complete, see Revenue Procedure 92–29. However, if you received explicit consent from the IRS to use Revenue Procedure 75–25 (as amplified in Revenue Procedure 78–25), you may continue to use this revenue procedure for sales of lots covered by the consent, including sales occurring after December 31, 1992.

Use of erroneous cost basis. If you made a mistake in figuring the cost basis of subdivided lots that you sold in previous years, you cannot correct the mistake for years for which the statute of limitations has expired. Figure the basis of any remaining lots by allocating the correct original cost basis of the entire tract among the original lots.

Example. You bought a tract of land to which you assigned a cost of $15,000. You subdivided the land into 15 building lots of equal size and equitably divided your basis so that each lot had a basis of $1,000. You treated the sale of each lot as a separate transaction and figured gain or loss separately on each sale.

Several years later you determine that your original basis in the tract was $22,500 and not $15,000. You sold eight lots using $8,000 of basis in years for which the statute of limitations has expired. You now can take $1,500 of basis into account for figuring gain or loss only on the sale of each of the remaining seven lots ($22,500 basis divided among all 15 lots). You cannot refigure (to $1,500) the basis of the eight lots sold in tax years barred by the statute of limitations.

Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property, or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. This includes the cost of any improvements having a useful life of more than 1 year and amounts spent after a casualty to restore the damaged property.

Rehabilitation expenses also increase basis. However, you must subtract any rehabilitation credit allowed for these expenses before you add them to your basis. If you have to recapture any of the credit, increase your basis by the amount of the recapture.

If you make additions or improvements to business property, keep separate accounts for them. Also, depreciate the basis of each according to the depreciation rules in effect when you place the addition or improvement in service. For more information, see Publication 946.

Some items added to the basis of property are:

1) The cost of extending utility service lines to the property,
2) Legal fees, such as the cost of defending and perfecting title,
3) Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements,
4) Zoning costs, and
5) The capitalized value of a redeemable ground rent.

Assessments for Local Improvements

Add assessments for items such as streets and sidewalks, which increase the value of the property assessed to the basis of the property. Do not deduct them as taxes. However, you can deduct assessments for maintenance, repair, or meeting interest charges on the improvements as taxes.

Example. If your city changes the street in front of your store into an enclosed pedestrian mall, and assesses you and other affected landowners for the cost of the conversion, add the assessment to your property's basis. In this example, the amount of the assessment is a depreciable asset.

Deducting vs. Capitalizing Costs

Do not add to your basis costs you can deduct as current expenses. However, you can choose either to deduct or to capitalize certain other costs. If you capitalize these costs, include them in your basis. If you deduct them, do not include them in your basis. (See *Uniform Capitalization Rules,* earlier.)

The costs you can choose to deduct or to capitalize include:

1) Carrying charges, such as interest and taxes, that you pay to own property,
2) Research and experimentation costs,
3) Intangible drilling and development costs for oil, gas, and geothermal wells,
4) Exploration costs for new mineral deposits,
5) Mining development costs for a new mineral deposit,
6) The cost of increasing the circulation of a newspaper or other periodical, and
7) The cost of removing architectural and transportation barriers to people with disabilities and the elderly.

For more information about deducting or capitalizing costs, see chapter 11 in Publication 535.

Decreases to Basis

Some items that reduce the basis of your property are:

1) The section 179 deduction,
2) The deduction for clean-fuel vehicles and clean-fuel vehicle refueling property,
3) Nontaxable corporate distributions,
4) Deductions previously allowed (or allowable) for amortization, depreciation, and depletion,
5) Exclusion from income of subsidies for energy conservation measures,
6) Credit for qualified electric vehicles,
7) Gain from the sale of your old home on which tax was postponed,
8) Investment credit (part or all of credit) taken,
9) Casualty and theft losses,
10) Certain canceled debt excluded from income,
11) Rebates received from the manufacturer or seller,
12) Easements,
13) Residential energy credit,

Table 1. **Examples of Increases and Decreases to Basis**

Increases to Basis	Decreases to Basis
Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home	Exclusion from income of subsidies for energy conservation measures Casualty or theft loss deductions and insurance reimbursements Credit for qualified electric vehicles
Assessments for local improvements: Water connections Sidewalks Roads	Gain from the sale of your old home on which tax was postponed Section 179 deduction
Casualty losses: Restoring damaged property	Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property
Legal fees: Such as the cost of defending and perfecting a title Zoning costs	Depreciation Nontaxable corporate distributions

14) Gas-guzzler tax, and
15) Tax credit or refund for buying a diesel-powered highway vehicle.

Some of these decreases to basis are discussed next.

Casualty and Theft Losses

If you have a casualty or theft loss, decrease the basis in your property by the amount of any insurance or other reimbursement you receive and by any deductible loss not covered by insurance. However, increase your basis by amounts you spend after a casualty to restore the damaged property. For more information on casualty and theft losses of business property, see chapter 25 in Publication 334, *Tax Guide for Small Business.* For more information on casualty and theft losses of nonbusiness property, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts.*

Easements

The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain.

Credit for Qualified Electric Vehicles

If you claim the credit for qualified electric vehicles, you must reduce the basis of the property on which you claimed the credit. For more information on this credit, see chapter 15 in Publication 535.

Residential Energy Credit

The residential energy credit is no longer available. However, if in the past, you were allowed the credit, decrease the basis of your home by the credit allowed if you added the cost of the energy items to the basis of your home.

Gas-Guzzler Tax

Decrease the basis in your car by the gas-guzzler (fuel economy) tax if you begin using the car within 1 year of the date of its first sale for ultimate use. This rule also applies to someone who later buys the car and begins using it not more than 1 year after the original sale for ultimate use. If the car is imported, the one-year period begins on the date of entry or withdrawal of the car from the warehouse if that date is later than the date of the first sale for ultimate use.

Diesel-Powered Vehicle

If you received an income tax credit or refund for buying a diesel-powered highway vehicle, reduce your basis in that vehicle by the credit or refund allowable. For more information about this credit or refund, see Publication 378, *Fuel Tax Credits and Refunds.*

Section 179 Deduction

If you take the section 179 deduction for all or part of the cost of business property, decrease the basis of the property by the deduction. For more information about the section 179 deduction, see Publication 946.

Deduction for Clean-Fuel Vehicles and Clean-Fuel Vehicle Refueling Property

If you take either the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, or both, you must decrease the basis of the property by the amount of the deduction. For more information on these deductions, see chapter 15 in Publication 535.

Exclusion from Income of Subsidies for Energy Conservation Measures

If you received a subsidy from a public utility company for the purchase or installation of any energy conservation measure, you can exclude it from income. Reduce the basis of the property on which you received the subsidy by the excluded amount. For more information on this subsidy, see Publication 525.

Depreciation

Decrease the basis of your property by the depreciation you could have deducted on your tax returns under the method of depreciation you selected. If you took less depreciation than you could have under the method you selected, decrease the basis by the amount you could have taken under that method. If you did not take a depreciation deduction, then make adjustments to basis for depreciation you could have taken.

If you deducted more depreciation than you should have, decrease your basis as follows. Decrease it by an amount equal to the depreciation you should have deducted, as well as by the part of the excess depreciation you deducted that actually reduced your tax liability for any year.

In decreasing your basis for depreciation, take into account the amount deducted on your tax returns as depreciation, and any depreciation you must capitalize under the uniform capitalization rules.

For information on figuring the depreciation you should have claimed, see Publication 946, *How To Depreciate Property.*

If you are claiming depreciation on a car you use in your trade or business, see Publication 917. If the car is not used more than 50% for business during the tax year, you may have to recapture excess depreciation. Include the excess depreciation in your gross income and add it to your basis in the property. For information on the computation of excess depreciation, see Publication 917.

Canceled Debt Excluded from Income

If a debt is canceled of forgiven, other than as a gift or bequest, the debtor generally must include the canceled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable or which attaches to property the debtor holds. You can exclude your canceled debt from income if the debt is:

1) Canceled in a title 11 bankruptcy case or when you are insolvent,
2) Qualified farm debt, or
3) Qualified real property business indebtedness (provided you are not a C corporation).

If you exclude canceled debt from income, you may have to reduce the basis of your depreciable property.

For more information on canceled debt in a bankruptcy case or during insolvency see Publication 908, *Tax Information on Bankruptcy.*

For more information on canceled debt that is qualified farm debt, see chapter 4 in Publication 225, *Farmer's Tax Guide.*

Adjusted Basis Example

In January 1990, you paid $80,000 for real property to be used as a factory. You also paid commissions of $2,000 and title search and legal fees of $600. You allocated the total cost of $82,600 between the land and the building—$10,325 for the land and $72,275 for the building. Immediately, you spent $20,000 in remodeling the building before you placed it in service. You were allowed depreciation of $14,526 for the years 1990 through 1994. In 1993 you had a casualty loss that was not covered by insurance of $5,000 on the building from a fire. This loss was claimed as a deduction. You spent $5,500 to repair the fire damages. The adjusted basis of the building on January 1, 1995, is figured as follows:

Original cost of building, including fees and commissions		$72,275
Adjustments to basis:		
Add:		
Improvements		20,000
Repair of fire damage		5,500
		$97,775
Subtract:		
Depreciation	$14,526	
Casualty loss	5,000	19,526
Adjusted basis on January 1, 1995		$78,249

The basis of the land, $10,325, remains unchanged. It is not affected by any of the above adjustments, which affect only the basis of the building.

Other Basis

There are many times when you cannot use cost as basis. In these cases, the FMV or the adjusted basis of property may be used. Adjusted basis is defined in the preceding discussion, and FMV is defined next.

Fair market value (FMV). FMV is the price at which the 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. Sales of similar property, on or about the same date, may be helpful in figuring the property's FMV.

Property Received for Services

If you receive property for services, include the property's FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Bargain Purchases

A bargain purchase is a purchase of an item for less than its FMV. If your employer lets you purchase goods or other property at less than FMV, include the difference between the purchase price and FMV of the property in your income. Your basis in the property is its FMV, that is, your purchase price plus the amount you include in your income.

If the difference between your purchase price and the FMV represents a ***qualified employee discount,*** do not include the amount in income.

Restricted Property

If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested, unless you make the election discussed later. Property becomes substantially vested when you can transfer it or it is not subject to a substantial risk of forfeiture.

When the property becomes substantially vested, include the FMV, less any amount you paid for the property, in income. Your basis in the property is its FMV.

There is substantial risk of forfeiture when your rights to full enjoyment of the property depend on your future performance of substantial services.

Example. Your employer gives you stock for services performed under the condition that you will have to return the stock unless you complete 5 years of service. You need not report any income until you have completed the 5 years of service that satisfy the condition.

Fair market value. Figure the FMV of property you received without considering any restriction except one that by its terms will never end.

Example. You received under the following conditions stock from your employer for services you performed. If you want to sell the stock while still employed, you must sell the stock to your employer at book value. At your retirement or death, you or your estate must offer to sell the stock to your employer at its book value. This is a restriction that by its terms will never end and you consider it when you figure the FMV.

Election. You may choose to include in your gross income the FMV of the property at the time of transfer, less any amount you paid for it. If you make this choice, the substantial vesting rules do not apply. Your basis is the amount you paid plus the amount you included in your income.

See the discussion of *Restricted Property Received for Services* in Publication 525 for more information.

Taxable Exchanges

A taxable exchange is one on which the gain is taxable, or the loss is deductible. If you receive property in exchange for other property in a taxable exchange, the basis of property you received is usually its FMV at the time of exchange.

Involuntary Exchanges

If you acquire property as a result of an involuntary exchange, such as a casualty, theft, or condemnation, you may figure the basis of the replacement property you acquire using the basis of the property you exchanged.

Similar or related property. If you receive property that is similar or related in service or use to the property exchanged, the new property's basis is the old property's basis on the date of the exchange with the following adjustments:

Decreased by—

a) Any loss recognized on the exchange, and

b) Any money received that was not spent on similar property.

Increased by—

a) Any gain recognized on the exchange, and

b) Any cost of acquiring replacement property.

Not similar or related property. If you receive money or other property that is not similar or related in service or use to the old property, and you buy new property that is similar or related in service or use to the old property, the basis of the new property is the cost of the new property, decreased by the amount of gain that is not recognized on the exchange.

Example. The state condemned your property. The property had an adjusted basis of $26,000, and the state paid you $31,000 for it. You realized a gain of $5,000 ($31,000 − $26,000). You bought new property that is similar in use to the old property for $29,000. You recognize a gain of $2,000 ($31,000 − $29,000), the unspent part of the payment from the state. The basis of the new property is figured as follows:

Cost of new property	$29,000
Minus: Gain not recognized	3,000
Basis of the new property	$26,000

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Example. If, in the previous example, the state had condemned unimproved real property and the new property you bought was improved real property with both land and buildings, you would make an allocation. Take the new property's $26,000 basis and allocate it between land and buildings based on their costs.

For more information about involuntary exchanges, see *Involuntary Conversions* in Publication 544.

Nontaxable Exchanges

Terms you may need to know (see Glossary):

Intangible property
Like-class property
Like-kind property
Personal property
Real property
Tangible property

A nontaxable exchange is an exchange in which any gain is not taxed and any loss cannot be deducted. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you exchanged.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange.

To qualify as a like-kind exchange, both the property you exchange and the property you receive must be held by you for business or investment purposes. There must be an exchange of like property. For other requirements, see *Like-Kind Exchanges,* in Publication 544.

The basis of the property you receive is the same as the basis of the property you gave up.

Example. You exchange real estate (adjusted basis $50,000, FMV $80,000) held for investment for other real estate (FMV $80,000) held for investment. Your basis in the new property is the same as the basis of the old ($50,000).

Exchange expenses. Exchange expenses are generally the closing costs that you pay. They include such items as brokerage commissions, attorney fees, deed preparation fees, etc. Add them to the basis of the like-kind received.

Property plus cash. If you trade property in a nontaxable exchange and pay money, the basis of the property received is the basis of the property exchanged increased by the money paid.

Example. You trade in a truck (adjusted basis $3,000) for another truck (FMV $7,500) and pay $4,000. Your basis in the new truck is $7,000 (the $3,000 basis of the old truck plus the $4,000 paid).

Special rules for related persons. If a like-kind exchange is made directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange is disqualified from like-kind exchange treatment. Each person must report any gain or loss not recognized on the original exchange. Each person reports it on the tax return filed for the year in which the later disposition occurred. If this special rule applies, the basis in the property received in the original exchange will be its fair market value.

These rules generally do not apply to dispositions due to:

1) The death of either related person,

2) Involuntary conversions, or

3) Exchanges whose main purpose is not the avoidance of federal income tax.

Related persons. Generally, related persons are ancestors, lineal descendants, brothers and sisters (whole or half), and a spouse.

For other related persons (i.e., two or more corporations, an individual and a corporation, a grantor and fiduciary, etc.), see *Nondeductible Loss* in chapter 2 of Publication 544.

Exchange of businesses. Exchanging the assets of one business for the assets of another business is a multiple asset exchange. For information on determining basis in a multiple asset exchange, see *Multiple Property Exchanges* in Publication 544.

Partially Nontaxable Exchange

A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the basis of the old property with the following adjustments:

Decreased by—

a) Any money you received, and

b) Any loss recognized on the exchange.

Increased by—

a) Any additional costs incurred, and

b) Any gain recognized on the exchange.

The other party to the transaction who assumes your liabilities (including a nonrecourse obligation) treats them as money transferred to you in the exchange.

Allocate the basis among the properties, other than money, you received in the exchange. In making this allocation, the basis of the unlike property is its FMV on the date of the exchange. The remainder is the basis of the like property.

Example 1. You exchange a truck (adjusted basis $6,000) for a new truck (FMV $5,200) and $1,000. You have a recognized gain of $200 ($6,200 – $6,000). Your basis in the new truck is:

Adjusted basis of old truck	$6,000
Minus: Cash you received	1,000
	$5,000
Plus: Gain recognized	200
Basis of new truck	$5,200

Example 2. You had an adjusted basis of $15,000 in real estate you held for investment. You exchange it for other real estate to be held for investment with an FMV of $12,500, a truck with an FMV of $3,000, and $1,000. You have a gain of $1,500 ($16,500 – $15,000) recognized on the exchange. Your basis in the properties you received is:

Adjusted basis of real estate transferred	$15,000
Minus: Cash received	1,000
	$14,000
Plus: Gain recognized	1,500
Total basis of properties received	$15,500

Allocate the total basis of $15,500 between the truck and the real estate. The basis of the truck is its FMV, $3,000, and the basis of the real estate is the remainder, $12,500.

Trade-In or Sale and Purchase

If a sale and purchase are a single transaction, you cannot increase the basis of property for depreciation by selling your old property outright to a dealer and then buying new property from the same dealer. If the sale of your old property to the dealer and the purchase of new property from that dealer are dependent on each other, you are considered to have traded in your old property. Treat the transaction as an exchange no matter how it is carried out. You cannot avoid this trade-in rule by using a subsidiary in the transaction.

Example. You are a salesperson and you use one of your cars 100% for business. You have used this car in your sales activities for 2 years and have depreciated it. Your adjusted basis in the car is $22,600 and its FMV is $23,100. You are interested in a new car with a listed retail price of $28,695, which usually sells for $28,000. If you trade your old car and $4,900 for the new one your basis for depreciation for the new car would be $27,500 ($4,900 plus $22,600 basis of your old car). However, you want a higher basis for depreciating the new car, so you agree to pay the dealer $28,000 for the new car if he will pay you $23,100 for your old car. Since the sale and purchase are dependent on each other, you are treated as if you had exchanged your old car for the new one. Your basis for depreciating the new car is $27,500, which is the same as it would be if you traded the old car.

Partial Business Use of Property

If you have property used partly for business and partly for personal use, and you exchange it in a nontaxable exchange for property to be used wholly or partly in your business, the basis of the property you receive is figured as if you exchanged two properties. The first is an exchange of like-kind property. The second is personal-use property on which gain is recognized and loss is not recognized.

First, figure your adjusted basis in the property you transfer as if you transferred two separate properties. Figure the adjusted basis of each part of the property by taking into account any adjustments to basis. Deduct the depreciation you took or should have taken from the adjusted basis of the business part. Then figure the amount realized for your property and allocate it to the business and nonbusiness parts of the property you transferred.

In this case, you exchanged property permitted to be exchanged tax free. Recognize any gain from the transaction on your personal-use property. The basis of the property acquired is the total basis of the properties transferred, adjusted to the date of the exchange, increased by the gain, recognized on the other property. You are deemed to have received in exchange for your other property an amount equal to its FMV on the date of exchange.

Listed property. Special rules apply to listed property not used 100% in your business. Listed property includes:

Any automobile, or other property used for transportation,

Property used for entertainment such as photographic and video recording equipment,

Cellular telephone or similar equipment, and

Computers and related peripheral equipment not used exclusively at a regular business location.

Under a special rule, when listed property used less than 100% for business is traded for business property, your ***basis for depreciating*** the newly acquired property must be adjusted. First, figure the adjusted basis of the old property. Add to this adjusted basis any additional amount paid for the new property. Finally, subtract from that total any remainder of:

1) The depreciation that would have been allowable if the old property had been used 100% for business or investment purposes, over
2) The depreciation allowed for the old property.

Use this adjusted basis only for depreciating the new property. Do not use it to figure a gain or loss on the sale of the new property.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis (defined earlier) to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV Less Than Donor's Adjusted Basis

If the FMV of the property was less than the donor's adjusted basis, your basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis,* earlier). Your basis for loss on its sale or other disposition is its FMV at the time you received the gift plus or minus any required adjustment to basis during the period you held the property (see *Adjusted Basis,* earlier).

If you use the donor's adjusted basis for figuring a gain and get a loss, and then use the FMV for figuring a loss and get a gain, you have neither gain nor loss on the sale or disposition of the property.

Example. You received an acre of land as a gift. At the time of the gift, the acre had an FMV of $8,000. The donor's adjusted basis was $10,000. After you received the property, no events occur that would increase or decrease your basis in it. If you later sell the property for $12,000, you will have a $2,000 gain because you must use the donor's adjusted basis ($10,000) at the time of the gift to report a gain. If, however, you sell the property for $7,000, you will have a $1,000 loss because you must use the FMV ($8,000) at the time of the gift to report a loss.

If the sales price is between $8,000 and $10,000, you have neither gain nor loss. For instance, if the sales price was $9,000 and you tried to figure a gain using the donor's adjusted basis ($10,000), you would get a $1,000 loss. If you then tried to figure a loss using the FMV ($8,000), you would get a $1,000 gain.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV Equal to or More Than Donor's Adjusted Basis

If the FMV of the property was equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of the gift tax paid, depending on the date of the gift.

Also, for figuring gain or loss from a sale or other disposition of the property or figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis,* earlier.

Gift received before 1977. If you received a gift before 1977, increase your basis in the gift by the gift tax paid on it. (Your basis in the gift is the donor's adjusted basis.) However, do not increase your basis above the FMV of the gift when it was given to you.

Example 1. You were given a house in 1976 with a FMV of $21,000. The donor's adjusted basis was $20,000. The donor paid a gift tax of $500. Your basis is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. If, in Example 1, the gift tax paid had been $1,500, your basis would be $21,000. This is the donor's adjusted basis plus the gift tax paid, limited to the FMV of the house at the time you received the gift.

Gift received after 1976. If you received a gift after 1976, increase your basis in the gift by the part of the gift tax paid that is due to the net increase in value of the gift. (Your basis in the gift is the donor's adjusted basis.) Figure the increase by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) of the fraction is the net increase in value of the gift, and the denominator (bottom part) is the amount of the gift. The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis.

Example. In 1995, you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. She paid a gift tax of $9,000. Your basis, $25,400, is figured as follows:

Fair market value	$50,000
Minus: Adjusted basis	20,000
Net increase in value	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	.60
Gift tax due to net increase in value	$ 5,400
Adjusted basis of property to your mother	20,000
Your basis in the property	$25,400

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse, or former spouse if the transfer is incident to divorce, is the same as the transferor's adjusted basis. However, adjust your basis for any gain recognized by the transferor on a property transferred in trust. This rule applies only to a property transferred in trust in which the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred is a Series E or EE United States savings bond, the transferor must include in income the interest accrued to the date of transfer. The transferee's basis in the bond immediately after the transfer is equal to the transferor's adjusted basis increased by the interest income includable in the transferor's income.

The transferor must supply you with records necessary to determine the adjusted basis and holding period of the property as of the date of transfer.

For more information, see Publication 504, *Divorced or Separated Individuals.*

Inherited Property

Your basis in property you inherit is usually its FMV at the date of the decedent's death. If a federal estate tax return has to be filed, your basis in property you inherit can be its fair market value at the alternate valuation date if the estate qualifies and elects to use alternate valuation. If a federal estate tax return does not have to be filed, your basis in the property is its appraised value at the date of death for state inheritance or transmission taxes.

Your basis in inherited property may also be figured under the special farm or closely held business real property valuation method, if chosen for estate tax purposes. This method is discussed later. For more information on the alternate valuation date, see Publication 448.

Appreciated property. The above rule does not apply to appreciated property you receive from a decedent if you or your spouse originally gave the property to the decedent within

1 year before the decedent's death. Your basis in this property is the same as the decedent's adjusted basis in the property immediately before his or her death, rather than its FMV. Appreciated property is any property whose FMV on the day it was given to the decedent is more than its adjusted basis.

Community Property

In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), husband and wife are each usually considered to own half the community property. When either spouse dies, the total value of the community property generally becomes the basis of the entire property, even the part belonging to the surviving spouse. For this to apply, at least half the community property interest must be includable in the decedent's gross estate, whether or not the estate must file a return.

For example, if at least half the FMV of the community interest is includable in the decedent's estate and the FMV of the community interest is $100,000, the basis of the surviving spouse's half of the property is $50,000. The basis of the other half to the decedent's heirs is also $50,000.

For more information on community property, see Publication 555, *Federal Tax Information on Community Property.*

Property Held by Surviving Tenant

The following example explains the rule for the basis of property held by a surviving tenant in a joint tenancy or tenancy by the entirety.

Example. John and Jim owned, as joint tenants, business property that they purchased for $30,000. John furnished two-thirds of the purchase price and Jim furnished one-third. Depreciation deductions allowed before John's death were $12,000. At the date of John's death, the property had an FMV of $60,000, two-thirds of which is includable in John's estate. Under local law, John and Jim as joint tenants each had a half interest in the income from the property. Jim figures his basis in the property at the date of John's death as follows:

Interest Jim bought with his own funds—1/3 of $30,000 cost	$10,000	
Interest Jim received on John's death—2/3 of $60,000 fair market value	40,000	$50,000
Minus: 1/2 of $12,000 depreciation before John's death		6,000
Jim's basis at the date of John's death		$44,000

If Jim had not contributed any part of the purchase price, his basis at the date of John's death would be $54,000. This is figured by subtracting the $6,000 depreciation on the half interest that he acquired before the date of death from the $60,000 FMV.

If, under local law, Jim had no interest in the income from the property and if he contributed no part of the purchase price, his basis at John's death would be $60,000. This $60,000 is the FMV of the property.

Qualified Joint Interest

Include one-half of the value of a qualified joint interest in the decedent's gross estate. It does not matter how much each spouse contributed to the purchase price. Also, it does not matter which spouse dies first.

A qualified joint interest is any interest in property held by husband and wife as:

1) Tenants by the entirety, or
2) Joint tenants with right of survivorship, if husband and wife are the only joint tenants.

Basis. As the surviving spouse, your basis in property that you owned with your spouse as a qualified joint interest is the cost of your half of the property with some adjustments. Decrease the cost by any deductions allowed to you for depreciation and for depletion. Increase the reduced cost by your basis in the half you inherited. This basis is the FMV at your spouse's date of death, or at the alternate valuation date if elected for estate tax purposes, or the basis figured under the special farm or other closely held business real property valuation method, if elected for estate tax purposes.

Farm or Closely Held Business

Under certain conditions, when a person dies the executor or personal representative of that person's estate may elect to value the qualified real property on other than its FMV. If so, the executor or personal representative values the qualified real property on the basis of its use as a farm or its use in a closely held business. If this method of valuation is used for estate tax purposes, that value is the basis of the property for the heirs. The qualified heirs should be able to get the necessary value from the executor or personal representative of the estate.

If you are a qualified heir who received special-use valuation property, your basis in the property is the estate's or trust's basis in that property immediately before the distribution. If there is a gain recognized by the estate or trust because of post-death appreciation, increase the basis by this amount. Post-death appreciation is the difference between the property's FMV on the date of distribution and the property's FMV either on the date of the individual's death or the alternate valuation date. Figure all FMVs without regard to the special-use valuation.

Your basis in special-use valuation property may be increased if it becomes subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent (15 years if decedent died before 1982) you transfer the property to a person who is not a member of your family or the property ceases to be used as a farm or in a closely held business. To increase your basis in the property, you must make an irrevocable election. You must also pay the interest on the additional estate tax figured from the date 9 months after the decedent's death until the due date for paying the additional estate tax. If you meet these requirements, increase your basis in the property to its FMV on the date of the decedent's death or the alternate valuation date. The increase in your basis is considered to have occurred immediately before the event that results in the additional estate tax.

You make the election by filing with Form 706–A a statement that:

1) Contains your name, address, and taxpayer identification number,
2) Identifies the election as an election under section 1016(c) of the Internal Revenue Code,
3) Specifies the property for which the election is made, and
4) Provides any additional information required by the instructions and accompanying Form 706–A.

For more information, see Publication 448.

Property Changed to Business or Rental Use

When you hold property for personal use and change it to business use or use it to produce rent, you must figure the basis for depreciation. An example of this would be renting out your former main home.

Basis for depreciation. The basis for depreciation equals the lesser of:

1) The FMV of the property on the date of the change, or
2) Your adjusted basis on the date of the change.

Example. Several years ago you paid $160,000 to have your home built on a lot that cost you $20,000. Before changing the property to rental use last year, you paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house. Because land is not depreciable, you can only include the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you change its use is $178,000 ($160,000 + $20,000 − $2,000). On the date of change in use your property has an FMV of $180,000, of which $15,000 is for the land and $165,000 is for the house. The basis for depreciation on the house is the FMV on the date of change ($165,000), because it is less than your adjusted basis ($178,000).

Sale of property. If you later sell or dispose of the property, the basis of the property you use will depend on whether you are figuring gain or loss.

Gain. The basis for gain is your adjusted basis when you sell the property.

Example. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $37,500 you sell the property at a gain. Your adjusted basis in this case would be $160,500 ($178,000 + $20,000 (land) − $37,500).

Loss. Figure the basis for loss using the smaller of your adjusted basis or the FMV of the property at the time of the change.

Example. Assume the same facts as in the previous example, except that after being allowed depreciation deductions of $37,500, you sell the property at a loss. Your adjusted basis in this case would be the FMV ($180,000) because it is less than the adjusted basis ($198,000) on the date of the exchange. That amount ($180,000) is reduced by the depreciation deduction to arrive at a basis of $142,500 ($180,000– $37,500.)

Glossary

The definitions in this glossary are the meanings of the terms as used in this publication. The same term used in another publication may have a slightly different meaning.

Amortization: A ratable deduction for the cost of certain intangible property over the period specified by law. Examples of costs that can be amortized are goodwill, agreement not to compete, and research and mining exploration costs.

Business assets: Property used in the conduct of a trade or business, such as business machinery and office furniture.

Capital assets: Generally, everything you own for personal purposes or investment is a capital asset. This includes your home, personal car, or stocks and bonds. It does not include inventory or depreciable property.

Capital expenses: These are costs that must be added to (increase the basis of) your business investments or your capital assets.

Capitalization: Adding costs, such as improvements, to the basis of assets.

Depletion: Yearly deduction allowed to recover your investment in minerals in place or standing timber. To take the deduction, you must have the right to income from the extraction and sale of the minerals or the cutting of the timber.

Depreciation: Ratable deduction allowed over a number of years to recover your basis in property that is used more than one year for business or income producing purposes.

Goodwill: Intangible property that represents the advantage or benefit acquired in a business beyond the value of its other assets. It is not confined to a name but can be attached to a particular area where business is transacted. It can also be attached to a list of customers or to other elements of value in a business as a going concern.

Intangible property: Property that cannot be perceived by the senses such as goodwill, patents, copyrights, etc.

Like-class property: Depreciable tangible personal properties within the same General Asset Class in Revenue Procedure 87–56 or Product Class in the *Standard Industrial Classification Manual.* See *Personal property* under *Like Property* in chapter 1 of Publication 544 for detailed information.

Like-kind property: Items of property with the same nature or character. The grade or quality of the properties does not matter. Examples are two vacant plots of land.

Nonbusiness assets: Property used for personal purposes, such as a home or family car.

Personal property: Property, such as machinery, equipment, or furniture, that is not real property.

Real property: Land and generally anything erected on, growing on, or attached to land, for example, a building.

Recapture: Amount of depreciation or section 179 deduction that must be reported as ordinary income when property is sold at a gain.

Section 179 deduction: This is a special deduction allowed against the cost of certain property purchased for use in the active conduct of a trade or business.

Tangible property: This is property that can be seen or touched, such as furniture and buildings.

Unstated interest: The part of the sales price treated as interest when an installment contract provides for little or no interest.