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Basis of Assets



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Contents

Important Reminder	1
Introduction	1
Cost Basis	2
Stocks and Bonds	2
Real Property	2
Business Assets	3
Allocating the Basis	4
Adjusted Basis	4
Increases to Basis	4
Decreases to Basis	5
Basis Other Than Cost	6
Property Received for Services	6
Taxable Exchanges	7
Nontaxable Exchanges	7
Like-Kind Exchanges	7
Property Transferred From a Spouse	8
Property Received as a Gift	8
Inherited Property	9
Property Changed to Business or Rental Use	10
How To Get Tax Help	10
Glossary	11
Index	12

Important Reminder

Assets held on January 1, 2001. If you made the election to treat an asset as sold and then reacquired on January 1, 2001 (January 2, 2001, for readily tradable stock), and you hold the asset for more than 5 years from that date, any future gain on the asset is eligible for an 18% (instead of 20%) capital gains tax rate. If you made the election, your basis in the reacquired asset is its closing market price (for readily tradable stock) or fair market value (for any other capital asset or property used in a trade or business) on the date you reacquired it.

Introduction

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure 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 the following sections.

- Cost Basis
- Adjusted Basis
- Basis Other Than Cost

The basis of property you buy is usually its cost. You may also have to capitalize (add to

basis) certain other costs related to buying or producing the property.

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 conversion and certain other circumstances.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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Useful Items

You may want to see:

Publication

- 463** Travel, Entertainment, Gift, and Car Expenses
- 523** Selling Your Home
- 525** Taxable and Nontaxable Income
- 527** Residential Rental Property
- 530** Tax Information for First-Time Homeowners
- 535** Business Expenses
- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 559** Survivors, Executors, and Administrators
- 564** Mutual Fund Distributions
- 587** Business Use of Your Home
- 946** How To Depreciate Property

Form (and Instructions)

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

See *How To Get Tax Help* near the end of this publication for information about getting publications and forms.

Cost Basis

Terms you may need to know (see Glossary):

Business 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, other property, or services. Your cost also includes amounts you pay for the following items.

- Sales tax.
- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

You may also have to capitalize certain other costs related to buying or producing property.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, minus 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.

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. Allocate the price among the various assets including any section 197 intangibles. See *Allocating the Basis*, later.

Stocks and Bonds

The basis of stocks or bonds you buy is generally the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the fair market value (FMV) or the previous owner's adjusted basis of stock.

You must adjust the basis of stocks for certain events that occur after purchase. See *Stocks and Bonds* in chapter 4 of Publication 550 for more information on the basis of stock.

Identifying stock or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stock or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities

you acquired first. For more information about identifying securities you sell, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550.

Mutual fund shares. If you sell mutual fund shares acquired at different times and prices, you can choose to use an average basis. For more information, see *Average Basis* in Publication 564.

Real Property

If you buy real property, certain fees and other expenses become part of your cost basis in the property.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes 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 as an expense in the year of purchase. Do not include that amount in the basis of the property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs for buying the property. You cannot include fees and costs for getting a loan on the property. (A fee for buying property is a cost that must be paid even if you bought the property for cash.)

The following items are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- 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.

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

The following items are some settlement fees and closing costs you **cannot** include in the basis of the property.

- 1) Fire insurance premiums.
- 2) Rent for occupancy of the property before closing.
- 3) Charges for utilities or other services related to occupancy of the property before closing.
- 4) Charges connected with getting a loan. The following are examples of these charges.

- a) Points (discount points, loan origination fees).
 - b) Mortgage insurance premiums.
 - c) Loan assumption fees.
 - d) Cost of a credit report.
 - e) Fees for an appraisal required by a lender.
- 5) Fees for refinancing a mortgage.

If these costs relate to business property, items (1) through (3) are deductible as business expenses. Items (4) and (5) must be capitalized as costs of getting a loan and can be deducted over the period of the loan.

Points. If you pay points to obtain a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information on how to deduct points, see *Points* in chapter 5 of Publication 535.

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

Assumption of mortgage. If you buy property and assume (or buy subject to) 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.

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

Constructing assets. If you build property or have assets built for you, your expenses for this construction are part of your basis. Some of these expenses include the following items.

- Cost of the land.
- Cost of labor and materials.
- Architect's fees.
- Building permit charges.
- Payments to contractors.
- Payments for rental equipment.
- Inspection fees.

In addition, if you own a business and use your employees, material, and equipment to build an asset, your basis would also include the following costs.

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

Do not deduct these expenses. You must capitalize them (include them in the asset's basis). Also, reduce your basis by any work opportunity credit, welfare-to-work credit, Indian employment credit, or empowerment zone employment credit allowable on the wages you pay in (1), above. For information about these credits, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.



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
 Capitalization
 Depletion
 Depreciation
 Fair market value
 Going concern value
 Goodwill
 Intangible property
 Personal property
 Recapture
 Section 179 deduction
 Section 197 intangibles
 Tangible property

If you purchase property to use in your business, your basis is usually its actual cost to you. If you construct, create, or otherwise produce property, you must capitalize the costs as your basis. In certain circumstances, you may be subject to the uniform capitalization rules, next.

Uniform Capitalization Rules

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

Activities subject to the rules. You must use the uniform capitalization rules if you do any of the following in your trade or business or activity carried on for profit.

- Produce real or tangible personal property for use in the business or activity.
- Produce real or tangible personal property for sale to customers.
- Acquire property for resale.

You produce property if you construct, build, install, manufacture, develop, improve, create, raise, or grow the property. Treat 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, you must capitalize all direct costs and an allocable part of most indirect costs you incur due to your production or resale activities. The term **capitalize** means to include certain expenses 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 deductions for depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

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

Example. If you incur a business meal expense for which your deduction would be limited to 50% of the cost of the meal, that amount is subject to the uniform capitalization rules. The nondeductible part of the cost is not subject to the uniform capitalization rules.

More information. For more information about these rules, see the regulations under section 263A of the Internal Revenue Code and Publication 538, *Accounting Periods and Methods*.

Exceptions. The following are not subject to the uniform capitalization rules.

- 1) Property you produce that you do not use in your trade, business, or activity conducted for profit.
- 2) Qualified creative expenses you pay or incur as a free-lance (self-employed) writer, photographer, or artist that are otherwise deductible on your tax return.
- 3) Property you produce under a long-term contract, except for certain home construction contracts.
- 4) Research and experimental 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 for the 3 previous tax years do not exceed \$10 million.

For other exceptions to the uniform capitalization rules, see section 1.263A-1(b) of the regulations.

For information on the special rules that apply to costs incurred in the business of farming, see chapter 7 of Publication 225, *Farmer's Tax Guide*.

Intangible Assets

Intangible assets include goodwill, patents, copyrights, trademarks, trade names, and franchises. The basis of an intangible asset is usually the cost to buy or create it. 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 9 of Publication 535 for information on the amortization of these costs.

Patents. The basis of a patent you get for an invention is the cost of development, such as research and experimental expenditures, drawings, working models, and attorneys' and gov-

ernmental 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 a copyright will usually be the 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 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 among the assets you receive. You must 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 among the assets 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 trade or business, allocate the consideration paid to the various assets acquired. Generally, reduce the consideration paid by any cash and general deposit accounts (including checking and savings accounts) received. Allocate the remaining consideration to the other business assets received in proportion to (but not more than) their fair market value in the following order.

- 1) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 2) Accounts receivable, other debt instruments, and assets you mark to market at least annually for federal income tax purposes.
- 3) Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held primarily for sale to customers in the ordinary course of business.
- 4) All other assets except section 197 intangibles, goodwill, and going concern value.
- 5) Section 197 intangibles except goodwill and going concern value.
- 6) Goodwill and going concern value (whether or not they qualify as section 197 intangibles).

Agreement. The buyer and seller may enter into a written agreement as to the allocation of any consideration or the fair market value (FMV) of any of the assets. This agreement is binding on both parties unless the IRS determines the amounts are not appropriate.

Reporting requirement. Both the buyer and seller involved in the sale of business assets 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 return for the year in which the sale occurred.

More information. See *Sale of a Business* in chapter 2 of Publication 544 for more information.

Land and Buildings

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

Figure the basis of each asset by multiplying the lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase. If you are not certain of the FMV of the land and buildings, you can allocate the basis 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 the costs as a current deduction.

Modification of building. A modification of a building will not be treated as a demolition if the following conditions are satisfied.

- 75 percent or more of the existing external walls of the building are retained in place as internal or external walls.
- 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 also 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, you must determine the basis of each lot. This 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.

To determine the basis of an individual lot, multiply the total cost of the tract by a fraction. The numerator is the FMV of the lot and the denominator is the FMV of the entire tract.

Future improvement costs. If you are a developer and sell subdivided lots before the development work is completed, you can (with IRS consent) include in the basis of the properties sold an allocation of the estimated future

cost for common improvements. See Revenue Procedure 92-29 for more information, including an explanation of the procedures for getting consent from the IRS.

Use of erroneous cost basis. If you made a mistake in figuring the cost basis of subdivided lots sold in previous years, you cannot correct the mistake for years for which the statute of limitations (generally 3 tax years) 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 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 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. These include the cost of any improvements having a useful life of more than 1 year.

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 recaptured amount.

If you make additions or improvements to business property, keep separate accounts for them. Also, you must depreciate the basis of each according to the depreciation rules that would apply to the underlying property if you had placed it in service at the same time you placed the addition or improvement in service. For more information, see Publication 946.

The following items increase the basis of property.

- The cost of extending utility service lines to the property.
- Impact fees.
- Legal fees, such as the cost of defending and perfecting title.
- Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.

Table 1. Examples of Increases and Decreases to Basis

Increases to Basis	Decreases to Basis
<p>Capital improvements:</p> <ul style="list-style-type: none"> Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home 	<p>Exclusion from income of subsidies for energy conservation measures</p>
<p>Assessments for local improvements:</p> <ul style="list-style-type: none"> Water connections Sidewalks Roads 	<p>Casualty or theft loss deductions and insurance reimbursements</p>
<p>Casualty losses:</p> <ul style="list-style-type: none"> Restoring damaged property 	<p>Credit for qualified electric vehicles</p>
<p>Legal fees:</p> <ul style="list-style-type: none"> Cost of defending and perfecting a title 	<p>Section 179 deduction</p>
<p>Zoning costs</p>	<p>Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property</p>
	<p>Depreciation</p>
	<p>Nontaxable corporate distributions</p>

- Zoning costs.
- The capitalized value of a redeemable ground rent.

Assessments for Local Improvements

Increase the basis of property by assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

Example. 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 assessment is a depreciable asset.

Deducting vs. Capitalizing Costs

Do not add to your basis costs you can deduct as current expenses. For example, amounts paid for incidental repairs or maintenance that are deductible as business expenses cannot be added to basis. 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 the following.

- Carrying charges, such as interest and taxes, that you pay to own property, except carrying charges that must be capitalized under the uniform capitalization rules.
- Research and experimentation costs.
- Intangible drilling and development costs for oil, gas, and geothermal wells.
- Exploration costs for new mineral deposits.
- Mining development costs for a new mineral deposit.

- Costs of establishing, maintaining, or increasing the circulation of a newspaper or other periodical.
- Cost of removing architectural and transportation barriers to people with disabilities and the elderly. If you claim the disabled access credit, you must reduce the amount you deduct or capitalize by the amount of the credit.

For more information about deducting or capitalizing costs, see chapter 8 in Publication 535.

Decreases to Basis

The following items reduce the basis of property.

- Section 179 deduction.
- Deduction for clean-fuel vehicles and refueling property.
- Nontaxable corporate distributions.
- Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
- Exclusion of subsidies for energy conservation measures.
- Credit for qualified electric vehicles.
- Postponed gain from sale of home.
- Investment credit (part or all) taken.
- Casualty and theft losses and insurance reimbursements.
- Certain canceled debt excluded from income.
- Rebates from a manufacturer or seller.
- Easements.
- Gas-guzzler tax.
- Tax credit or refund for buying a diesel-powered highway vehicle.
- Adoption tax benefits.
- Credit for employer-provided child care.

Some of these items are discussed next.

Casualties and Thefts

If you have a casualty or theft loss, decrease the basis in your property by any insurance or other reimbursement and by any deductible loss not covered by insurance.

You must increase your basis in the property by the amount you spend on repairs that substantially prolong the life of the property, increase its value, or adapt it to a different use. To make this determination, compare the repaired property to the property before the casualty. For more information on casualty and theft losses, see Publication 547, *Casualties, Disasters, and Thefts*.

Easements

The amount you receive for granting an easement is generally considered to be a sale of an interest in 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 in that part to zero and treat the excess as a recognized gain.

Credit for Qualified Electric Vehicles

If you claim the credit for a qualified electric vehicle, you must reduce your basis in that vehicle by the maximum credit allowable even if the credit allowed is less than that maximum amount. For information on this credit, see chapter 12 in Publication 535.

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.

Section 179 Deduction

If you take the section 179 deduction for all or part of the cost of qualifying 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 Refueling Property

If you take the deduction for clean-fuel vehicles or clean-fuel vehicle refueling property, decrease the basis of the property by the amount of the deduction. For more information about these deductions, see chapter 12 in Publication 535.

Exclusion of Subsidies for Energy Conservation Measures

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

Depreciation

Decrease the basis of property by the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you chose. If you took less depreciation than you could have under the method chosen, decrease the basis by the amount you could have taken under that method. If you did not take a depreciation deduction, reduce the basis by the full amount of the depreciation you could have taken.

Unless a timely election is made not to deduct the special depreciation allowance for property placed in service after September 10, 2001, decrease the property's basis by the special depreciation allowance you deducted or could have deducted.

If you deducted more depreciation than you should have, decrease your basis by the amount equal to the depreciation you should have deducted plus the part of the excess depreciation you deducted that actually reduced your tax liability for the year.

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

For information on figuring depreciation, see Publication 946.

If you are claiming depreciation on a business vehicle, see Publication 463. 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 chapter 4 in Publication 463.

Canceled Debt Excluded From Income

If a debt you owe is canceled or forgiven, other than as a gift or bequest, you generally must include the canceled amount in your gross income for tax purposes. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

You can exclude canceled debt from income in the following situations.

- 1) Debt canceled in a bankruptcy case or when you are insolvent.
- 2) Qualified farm debt.
- 3) Qualified real property business debt (provided you are not a C corporation).

If you exclude from income canceled debt under situation (1) or (2), you may have to reduce the basis of your depreciable and nondepreciable

property. However, in situation (3), you **must** reduce the basis of your depreciable property by the excluded amount.

For more information about canceled debt in a bankruptcy case or during insolvency, see Publication 908, *Bankruptcy Tax Guide*. For more information about canceled debt that is qualified farm debt, see chapter 4 in Publication 225. For more information about qualified real property business debt, see chapter 5 in Publication 334, *Tax Guide for Small Business*.

Postponed Gain From Sale of Home

If you postponed gain from the sale of your main home before May 7, 1997, you must reduce the basis of your new home by the postponed gain. For more information on the rules for the sale of a home, see Publication 523.

Adoption Tax Benefits

If you claim an adoption credit for the cost of improvements you added to the basis of your home, decrease the basis of your home by the credit allowed. This also applies to amounts you received under an employer's adoption assistance program and excluded from income. For more information on these benefits, see Publication 968, *Tax Benefits for Adoption*.

Employer-Provided Child Care

If you are an employer, you can claim the employer-provided child care credit on amounts you paid or incurred to acquire, construct, rehabilitate, or expand property used as part of your qualified child care facility. You must reduce your basis in that property by the credit claimed.

Example

In January 1997, 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 1997 through 2001. In 2000 you had a \$5,000 casualty loss from a fire that was not covered by insurance on the building. You claimed a deduction for this loss. You spent \$5,500 to repair the fire damages and extend the useful life of the building. The adjusted basis of the building on January 1, 2002, is figured as follows:

Original cost of building including fees and commissions	\$72,275	
Adjustments to basis:		
Add:		
Improvements	20,000	
Repair of fire damages	5,500	
		\$97,775
Subtract:		
Depreciation	\$14,526	
Deducted casualty loss	5,000	
		19,526
Adjusted basis on January 1, 2002		\$78,249

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

Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of property may be used. Adjusted basis is discussed earlier.

Fair market value (FMV). FMV is 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. 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, as compensation for services, you purchase goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

If the difference between your purchase price and the FMV represents a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Employee Discounts* in Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.

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 your rights in the property or the rights of any person to whom you transfer the property are not subject to a substantial risk of forfeiture.

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

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

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. The stock is under a substantial risk of forfeiture and is not substan-

tially vested when you receive it. You do 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 stock from your employer for services you performed. If you want to sell the stock while you are 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 must consider it when you figure the FMV.

Election. You can 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 substantially vested rules do not apply. Your basis is the amount you paid plus the amount you included in income.

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

Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss is also known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of property you receive is usually its FMV at the time of the exchange. A taxable exchange occurs when you receive cash or property not similar or related in use to the property exchanged.

Example. You trade a tract of farm land with an adjusted basis of \$3,000 for a tractor that has an FMV of \$6,000. You must report a taxable gain of \$3,000 for the land. The tractor has a basis of \$6,000.

Involuntary Conversions

If you receive property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, you can figure the basis of the replacement property you receive using the basis of the converted property.

Similar or related property. If you receive replacement property similar or related in service or use to the converted property, the replacement property's basis is the old property's basis on the date of the conversion. However, make the following adjustments.

- 1) Decrease the basis by the following.
 - a) Any loss you recognize on the conversion.
 - b) Any money you receive that you do not spend on similar property.
- 2) Increase the basis by the following.
 - a) Any gain you recognize on the conversion.
 - b) Any cost of acquiring the replacement property.

Money or property not similar or related. If you receive money or property not similar or related in service or use to the converted property, and you buy replacement property similar or related in service or use to the converted property, the basis of the new property is its cost decreased by the gain not recognized on the conversion.

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 replacement property similar in use to the converted property for \$29,000. You recognize a gain of \$2,000 (\$31,000 – \$29,000), the unspent part of the payment from the state. Your gain not recognized is \$3,000, the difference between the \$5,000 realized gain and the \$2,000 recognized gain. The basis of the new property is figured as follows:

Cost of replacement property	\$29,000
Minus: Gain not recognized	3,000
Basis of the replacement property	<u>\$26,000</u>

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. The state in the previous example condemned your unimproved real property and the replacement property you bought was improved real property with both land and buildings. Allocate the replacement property's \$26,000 basis between land and buildings based on their respective costs.

More information. For more information about condemnations, see *Involuntary Conversions* in Publication 544. For more information about casualty and theft losses, see Publication 547.

Nontaxable Exchanges

Terms you may need to know (see Glossary):

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

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is usually the same as the basis of the property you transferred. A nontaxable gain or loss is also known as an unrecognized gain or loss.

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, you must hold for business or investment purposes both the property you transfer and the property you receive. There must also be an exchange of like-kind property. For more information, 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 you pay. They include such items as brokerage commissions, attorney fees, deed preparation fees, etc. Add them to the basis of the like-kind property received.

Property plus cash. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the basis of the property you gave up increased by the money you 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 takes place directly or indirectly between related persons and either party disposes of the property within 2 years after the exchange, the exchange no longer qualifies for 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 occurs. If this rule applies, the basis of the property received in the original exchange will be its fair market value.

These rules generally do not apply to the following kinds of property dispositions.

- 1) Dispositions due to the death of either related person.
- 2) Involuntary conversions.
- 3) Dispositions in which neither the original exchange nor the subsequent disposition had as a main purpose 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 (for example, two corporations, an individual and a corporation, a grantor and fiduciary, etc.), see *Nondeductible Loss* in chapter 2 of Publication 544.

Exchange of business property. Exchanging the assets of one business for the assets of another business is a multiple property exchange. For information on figuring basis, see *Multiple Property Exchanges* in chapter 1 of 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 same as the basis of the property you gave up, with the following adjustments.

- 1) Decrease the basis by the following amounts.
 - a) Any money you receive.
 - b) Any loss you recognize on the exchange.
- 2) Increase the basis by the following amounts.
 - a) Any additional costs you incur.
 - b) Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Example. You traded a truck (adjusted basis \$6,000) for a new truck (FMV \$5,200) and \$1,000 cash. You realized a gain of \$200 (\$6,200 – \$6,000). This is the FMV of the truck received plus the cash minus the adjusted basis of the truck you traded (\$5,200 + \$1,000 – \$6,000). You include all the gain in income (recognized gain) because the gain is less than the cash received. Your basis in the new truck is:

Adjusted basis of old truck	\$6,000
Minus: Cash received (adjustment 1(a))	<u>1,000</u>
	\$5,000
Plus: Gain recognized (adjustment 2(b))	<u>200</u>
Basis of new truck	<u>\$5,200</u>

Allocation of basis. Allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like property.

Example. You had an adjusted basis of \$15,000 in real estate you held for investment. You exchanged 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 cash. The truck is unlike property. You realized a gain of \$1,500 (\$16,500 – \$15,000). This is the FMV of the real estate received plus the FMV of the truck received plus the cash *minus* the adjusted basis of the real estate you traded (\$12,500 + \$3,000 + \$1,000 – \$15,000). You include in income (recognize) all \$1,500 of the gain because it is less than the FMV of the unlike property plus the cash received. Your basis in the properties you received is figured as follows.

Adjusted basis of real estate transferred	\$15,000
Minus: Cash received (adjustment 1(a))	<u>1,000</u>
	\$14,000
Plus: Gain recognized (adjustment 2(b))	<u>1,500</u>
Total basis of properties received	<u>\$15,500</u>

Allocate the total basis of \$15,500 first to the unlike property — the truck (\$3,000). This is the truck's FMV. The rest (\$12,500) is the basis of the real estate.

Sale and Purchase

If you sell property and buy similar property in two mutually dependent transactions, you may have to treat the sale and purchase as a single nontaxable exchange.

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, which sells for \$28,000. If you trade your old car and pay \$4,900 for the new one, your basis for depreciation for the new car would be \$27,500 (\$4,900 plus the \$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. Because the two transactions are dependent on each other, you are treated as having exchanged your old car for the new one and paid \$4,900 (\$28,000 – \$23,100). Your basis for depreciating the new car is \$27,500, the same as 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 had 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 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 could 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.

The business part of the property is permitted to be exchanged tax free. However, you must recognize any gain from the exchange of the nonbusiness part. You are deemed to have received, in exchange for the nonbusiness part, an amount equal to its FMV on the date of the exchange. The basis of the property you acquired is the total basis of the property transferred (adjusted to the date of the exchange), increased by any gain recognized on the nonbusiness part.



If the nonbusiness part of the property transferred is your main home, you may qualify to exclude from income all or part of the gain on that part. For more information, see Publication 523.

Trade of car used partly in business. If you trade in a car you used partly in your business for another car you will use in your business, your basis for depreciation of the new car is not

the same as your basis for figuring a gain or loss on its sale.

For information on figuring your basis for depreciation, see Publication 463.

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 your spouse's adjusted basis. However, adjust your basis for any gain recognized by your spouse or former spouse on property transferred in trust. This rule applies only to a transfer of property 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 to you is a series E, series EE, or series I United States savings bond, the transferor must include in income the interest accrued to the date of transfer. Your basis in the bond immediately after the transfer is equal to the transferor's basis increased by the interest income includible in the transferor's income. For more information on these bonds, see Publication 550.

At the time of the transfer, the transferor must give you the 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*.

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 at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustment to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustment to basis while 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 have 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 land had an FMV of \$8,000. The donor's adjusted basis was \$10,000. After you received the land, no events occurred to increase or decrease your basis. If you sell the land 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 as your basis to figure gain. If you sell the land for

\$7,000, you will have a \$1,000 loss because you must use the FMV (\$8,000) at the time of the gift as your basis to figure 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 is 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 any 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 for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your 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 (the donor's adjusted basis) by any gift tax paid on it. However, do not increase your basis above the FMV of the gift at the time it was given to you.

Example 1. You were given a house in 1976 with an 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 (the donor's adjusted basis) by the part of the gift tax paid on it that is due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift less the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

Example. In 2002, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$39,000 (\$50,000 minus the \$11,000 annual exclusion). She paid a gift tax of \$9,000. Your basis, \$26,930, is figured as follows:

Fair market value	\$50,000
Minus: Adjusted basis	20,000
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$9,000
Multiplied by (\$30,000 ÷ \$39,000)77
Gift tax due to net increase in value	<u>\$6,930</u>
Adjusted basis of property to your mother	20,000
Your basis in the property	<u>\$26,930</u>

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- 1) The FMV of the property at the date of the individual's death.
- 2) The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation. For information on the alternate valuation date, see the instructions for Form 706.
- 3) The value under the special-use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes. This method is discussed later.
- 4) The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement. For information on a qualified conservation easement, see the instructions to Form 706.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

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, even the part belonging to the surviving spouse, generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includable in the decedent's gross estate, whether or not the estate must file a return.

For example, you and your spouse owned community property that had a basis of \$80,000. When your spouse died, half the FMV of the community interest was includable in your spouse's estate. The FMV of the community interest was \$100,000. The basis of your half of the property after the death of your spouse is

\$50,000 (half of the \$100,000 FMV). The basis of the other half to your spouse's heirs is also \$50,000.

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

Property Held by Surviving Tenant

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

Example. John and Jim owned, as joint tenants with right of survivorship, business property 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. Under local law, each had a half interest in the income from the property. 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. Jim figures his basis in the property at the date of John's death as follows:

Interest Jim bought with his own funds— $\frac{1}{3}$ of \$30,000 cost	\$10,000
Interest Jim received on John's death— $\frac{2}{3}$ of \$60,000 FMV	<u>40,000</u> \$50,000
Minus: $\frac{1}{2}$ of \$12,000 depreciation before John's death	<u>6,000</u>

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 from the \$60,000 FMV, the \$6,000 depreciation allocated to Jim's half interest before the date of death.

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

- Tenants by the entirety.
- Joint tenants with right of survivorship if husband and wife are the only joint tenants.

Basis. As the surviving spouse, your basis in property you owned with your spouse as a qualified joint interest is the cost of your half of the property with certain adjustments. Decrease the cost by any deductions allowed to you for depreciation and depletion. Increase the reduced cost by your basis in the half you inherited.

Farm or Closely Held Business

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

Special-use valuation. 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. Increase your basis by any gain recognized by the estate or trust because of post-death appreciation. Post-death appreciation is the property's FMV on the date of distribution minus 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.

You can elect to increase your basis in special-use valuation property if it becomes subject to the additional estate tax. This tax is assessed if, within 10 years after the death of the decedent, you transfer the property to a person who is not a member of your family or the property stops being used as a farm or in a closely held business.

To increase your basis in the property, you must make an irrevocable election and pay interest on the additional estate tax figured from the date 9 months after the decedent's death until the date of the payment of 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 does all of the following.

- 1) Contains your name, address, and taxpayer identification number and those of the estate.
- 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.
- 4) Provides any additional information required by the Form 706-A instructions.

For more information, see the instructions to Form 706 and Form 706-A.

Property Changed to Business or Rental Use

If you hold property for personal use and then change it to business use or use it to produce rent, you must figure its basis for depreciation. An example of changing property held for personal use to business use would be renting out your former main home.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- The FMV of the property on the date of the change.
- 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 \$25,000. You paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was \$178,000 (\$160,000 + \$20,000 - \$2,000). On the same date, your property had an FMV of \$180,000, of which \$15,000 was for the land and \$165,000 was for the house. The basis for figuring depreciation on the house is its 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 property changed to business or rental use, the basis of the property you use will depend on whether you are figuring gain or loss.

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

Example. Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of \$37,500. Your adjusted basis for figuring gain is \$165,500 (\$178,000 + \$25,000 (land) - \$37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use, as discussed earlier under *Adjusted Basis*, to arrive at a basis for loss.

Example. Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of \$37,500. In this case, you would start with the FMV on the date of the change to rental use (\$180,000) because it is less than the adjusted basis of \$203,000 (\$178,000 + \$25,000) on that date. Reduce that amount (\$180,000) by the depreciation deductions to arrive at a basis for loss of \$142,500 (\$180,000 - \$37,500).

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem

unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](ftp://ftp.irs.gov).



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order cur-

rent and prior year forms, instructions, and publications.

- **Asking tax questions.** Call the IRS with your tax questions at **1-800-829-1040**.
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- **TeleTax topics.** Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person

only evaluates the IRS assistant and does not keep a record of any taxpayer's name or tax identification number.

- We sometimes record telephone calls to evaluate IRS assistants objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.

- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at **www.irs.gov**. The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get a free copy by calling **1-800-829-3676** or visiting the IRS web site at **www.irs.gov**.

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.

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.

Fair market value (FMV): FMV is 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.

Going concern value: Going concern value is the additional value that attaches to property because the property is an integral part of an ongoing business activity. It includes value based on the ability of a business to continue to function and generate income even though there is a change in ownership.

Goodwill: Goodwill is the value of a trade or business based on

expected continued customer patronage due to its name, reputation, or any other factor.

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

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.

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.

Section 197 intangibles: Certain intangibles held in connection with the conduct of a trade or business or an activity entered into for profit, including goodwill, going concern value, patents, copyrights, formulas, franchises, trademarks, and trade names.

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.

Index

A	Comments	2	Group of assets acquired	4	Publications (See Tax help)	
Adjusted basis:	Community property	9				
Adoption tax benefits	Constructing assets	3	H		R	
Assessment for local	Copyrights	4	Help (See Tax help)		Real estate taxes	2
improvements	Cost basis:				Real property	2
Canceled debt	Allocating basis	4	I			
Casualty and theft losses	Assumption of mortgage	3	Inherited property	9	S	
Clean-fuel vehicle refueling	Capitalized costs	3, 5	Intangible assets	3	Settlement costs (fees)	2
property	Loans, low or no interest	2	Involuntary exchanges	7	Special-use valuation	10
Clean-fuel vehicles	Real estate taxes	2			Spouse, property transferred	
Credit for qualified electric	Real property	2	L		from	8
vehicles	Settlement costs (fees)	2	Land and buildings	4	Stocks and bonds	2
Decreases to			Loans, low or no interest	2	Subdivided lots	4
Depreciation	D				Suggestions	2
Easements	Decreases to basis	5	M			
Employer-provided child	Demolition of building	4	More information (See Tax help)		T	
care	Depreciation	6			Tax help	10
Example			N		Taxable exchanges	7
Gain from sale of home	E		Nontaxable exchanges:		Taxpayer Advocate	10
Gas-guzzler tax	Easements	5	Like-kind	7	Trade or business acquired	4
Increases to	Employer-provided child care . .	6	Partial	8	Trademarks and trade	
Section 179 deduction	Exchanges:				names	4
Subsidies for energy	Involuntary	7	P		Trading property (see	
conservation	Like-kind	7	Partially nontaxable		Exchanges)	7
Adoption tax benefits	Nontaxable	7	exchanges	8	TTY/TDD information	10
Allocating basis	Partial business use of		Patents	3		
Assistance (See Tax help)	property	8	Points	3	U	
Assumption of mortgage	Taxable	7	Property changed to		Uniform capitalization rules:	
			business use	10	Activities subject to the	
B	F		Property received as a gift	8	rules	3
Business acquired	Fair market value	6	Property received for services:		Exceptions	3
Business assets	Franchises	4	Bargain purchases	6		
Businesses exchanged	Free tax services	10	Fair market value	6		
			Restricted property	6		
C	G		Property transferred from a			
Canceled debt	Gain from sale of home	6	spouse	8		
Casualty and theft losses	Gifts, property received	8				
Change to business use						