

NF93-144



Determining Property Basis

by Ray Massey, Extension Economist
Gary Bredensteiner, Director Farm Management Operations

Overview

Whenever property is disposed of by sale, gift, trade or inheritance, a potential tax consequence exists. The gain or loss from the disposition of the property is determined by comparing the sale price to the adjusted basis in the property.

A person's original basis in an asset is determined by the way it was acquired -- whether through purchase, in trade, or received as a gift or inheritance. The original basis of the property is adjusted by deductions, such as depreciation, or by additions, such as capital improvements. Adjusted basis is the new basis after additions or deductions to the original basis have been made.

This NebFact will address how basis is initially determined by looking at each of the major ways of acquiring property. It will also briefly define adjusted basis. This NebFact is intended to be used as a supplementary aid in the publications that deal with estate planning, though the methods are not limited to use in estate planning.

Basis of Purchased and Constructed Property

The basis of purchased property is the purchase price plus payments such as freight, installation, option premiums paid, and other expenses of securing the property and preparing it for service. The basis of land includes the purchase price plus legal and recording fees, abstract fees, survey costs, and payments for nondepreciable permanent improvements.

When property is improved (eg. constructing buildings or fences), the basis is the total cost of the construction. This cost is not taken as an expense in the year of construction, rather the cost becomes the basis of the property, which is depreciated using the appropriate depreciation schedules for depreciable improvements.

Basis of Property Received as a Gift

Determining basis of property that is received as a gift can be complicated. To figure the basis of property received as a gift the recipient must know its basis to the donor just before it was given to the recipient -- its fair market value (FMV) at the time it was given and the amount of gift tax paid on it, if any.

If the FMV of the property when received is more than the donor's basis then the recipient's basis in the gift is the donor's basis plus all (for gifts received prior to 1977) or part (for gifts received after 1976) of any gift tax paid on it. The only limitation is that the recipient's basis cannot be above the FMV of the gift on the date it was given.

If the FMV of the property when it is received is less than the donor's basis, then the recipient's basis in the gift is usually the donor's basis. However, if a loss is incurred when the recipient disposes of the gifted property, the basis is not the donor's basis but is the FMV at the time the gift was given.

Basis of Inherited Property

The basis of inherited property is usually its fair market value at the time of the donor's death. There are three exceptions to this rule.

1. If a federal estate tax return is required and if the property must be included in the decedent's gross estate, the basis may be the special-use valuation if special-use valuation is elected.
2. If a federal estate tax return is required and if the property must be included in the decedent's gross estate, the basis may be the fair market value on the alternate valuation date if alternate valuation is elected. Special-use and alternate valuation are permitted only under special circumstances. For more information see NebFact 93-145, Special Use and Alternate Valuation of Estates.
3. When an heir, or an heir's spouse, gifted the property inherited to a person who dies within one year of the gift the basis of the inherited property is the deceased person's basis immediately before death rather than its fair market value. This is the same as the original owner's basis prior to the original gift. This rule came into effect in 1981 to prevent individuals from gaining the benefit of basis stepped up to fair market value by a temporary transfer of property to elderly persons.

For example, Betty Jones owns 160 acres of unimproved farm real estate with an adjusted basis of \$40,000 and fair market value of \$200,000. She intends to transfer the property to her son, Bill, either as a gift or through her estate after her death.

If Betty transfers the property by gift now to Bill, his basis in the property would be \$40,000 (donor's basis). Note that no gift tax would be paid but a reduction in Betty's unified gift and inheritance tax credit would occur. See NebFact 93-143, Federal Estate and Gift Taxes.

If Betty elects to transfer the property through her estate, Bill's basis would likely be the fair market value at the time of Betty's death (\$200,000 if Betty were to die today).

Property held by a surviving joint tenant is also figured differently. If the surviving co-owner of an asset is a spouse, the basis is the cost of the survivor's half of the property adjusted for increases or decreases due to capital investment or depreciation, plus the fair market value of the deceased spouse's half at the time of their death. If an alternate valuation date is elected, fair market value of the deceased spouse's half of the alternate valuation date is used in determining basis.

When unmarried persons hold property as joint tenants and one dies, the surviving joint tenant's basis is the survivor's original contribution to the cost of the property plus the fair market value of the deceased co-owner's share. This rule applies even if income from the property is shared in a way different from the

sharing of ownership.

Basis of Property Received in Trade

If only like kind property is received in an exchange, a taxable gain or loss is not figured in the year of the trade. However, the trade does affect the basis of property acquired in trade. The property acquired in trade has a basis equal to the basis of the property that was exchanged for it plus any additional money paid to acquire the property.

For example, if you trade land which has a basis of \$50,000 and a fair market value of \$100,000 for another tract of land that has a fair market value of \$100,000, the basis of the new property is \$50,000, the same basis as the old property.

When cash is paid during a trade, the basis of the property acquired is the basis of the property traded plus the cash difference. For example, if you traded land which has a basis of \$50,000 for another tract of land which has a fair market value of \$110,000 and also pay \$5,000 cash, the basis of the new property is \$55,000. This equals the \$50,000 basis of the land traded in plus the \$5,000 cash paid.

When unlike property or cash is received in addition to the like kind item, a partly tax free exchange may occur. The trade of land for land plus some piece of equipment would be a partly tax free exchange. The trade of a piece of equipment for real estate alone would not be a tax free exchange at all.

The basis computation for a partly tax free exchange is different than for a totally tax free exchange. It requires an adjustment to the basis of the old property. The basis of the property acquired is the basis of the old property less any money received in trade or any loss recognized on the trade plus any additional costs incurred or any gain recognized on the exchange.

If an exchange results in receipt of more than one type of property (part of it like the old property and part of it unlike the old property), basis must be divided among the properties received in the exchange. In making that division, the basis of the unlike property is its fair market value on the date of the exchange. The balance of the basis is then allocated to the like-kind property.

Adjusted Basis

Adjusted basis is used in calculating capital gain or loss. Adjusted basis reflects increases or decreases in the book value of an asset through time. The book value is the value which will be used to compute depreciation and gain or loss on the sale of the asset. Increases in basis result from improvements that add to book value. Decreases in basis result from depreciation, casualty loss, and other reductions in book value of the property. Adjusted basis is not a result of inflation and consequent change in the market value of assets.

Increases in Basis. Increases in basis result from improvements to property that have a useful life of more than one year. Generally the cost of improvements which add to the basis of an asset include supplies and materials purchased for major repairs or additions, legal fees, recording fees, and similar charges. Such increases in the basis are added to the capital account of the asset improved, resulting in a higher book value.

Decreases in Basis. Basis is reduced by any event that represents a return of capital. This includes depreciation, section 179 (expensing) deduction, casualty losses, and depletion. Basis is decreased by the

amount of any casualty related insurance or other reimbursement received and by any deductible loss not covered by insurance. Amounts spent after the casualty for restoration of property to its pre-casualty state of repair increase the basis.

Additional Information

IRS Publication 551, Basis of Assets.

The information contained in this NebFact is for educational purposes only. Tax is complicated and the information presented here has necessarily been simplified. See a tax consultant for specific questions.

NF144

Electronic version issued July 1995

pubs@unlvm.unl.edu