Chapter 5: Calculating Basis

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

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INTRODUCTION

Basis is a term that means little or nothing to the general public but can have a profound impact on the outcome of a tax return. To most tax professionals, the term basis represents a number needed to properly compute the tax on a given item. The computation of basis has differing results due to various circumstances. Many different types of assets or events are discussed in this chapter to illustrate the variations of basis. Basis itself is not important until it is needed to complete a return. It then becomes both a theoretical and a practical problem. If the information source for determining the basis is unavailable, it may be virtually impossible to determine the basis. For example, Aunt Bertha, who built the house she gave her daughter when she got married, is dead. The daughter is selling the house. The daughter may have to search for an alternative means of determining basis. This practical problem must be handled. If the basis cannot be determined, the IRS deems the basis to be zero.

The Internal Revenue Code discusses basis in 571 different documents. The number increases dramatically when the regulations, revenue procedures, and court documents are included.

INVESTMENT PROPERTY

Investment property is property held for appreciation or income. This includes property such as:

- Stocks,
- Mutual funds, and
- Real property.

STOCKS

For many shares of stock, the basis is its purchase price. However, there are factors that can alter the stock's basis. To determine the basis of a share of stock, the tax preparer must determine how the stock was acquired.

Purchase

The cost of acquiring stock is included in the basis. This includes brokerage commissions and transfer fees. Some brokerage statements state that the commissions are either included in the purchase price or deducted from the sales price.

The basis of purchased stock is reduced by nontaxable distributions called a return of capital. This is shown on the Form 1099-DIV, *Dividends and Distributions*. A nontaxable distribution is usually the result of a dividend payment when earnings and profits are not available for distribution.

Employment-Related Stock

In addition to purchasing stock, shares may be obtained through employment. This includes:

- Employee stock purchase plans (ESPP),
- Nonqualified stock options,
- Restricted stock options, and
- Incentive stock options (ISO).

Employee Stock Purchase Plan (ESPP). Employees may have the right to purchase stock at discounted rates through an ESPP. The stock follows the general rule of basis being equal to the purchase price. The ESPP requires the stock be held for a certain period of time before it can be sold. Stock purchased through an ESPP is limited to a maximum discount of 15%. When the employee sells the stock, the ESPP discount is shown on the employee's Form W-2.[1] This amount is then added to the basis of the stock. If the employee sells the stock for less than the option price, no amount is reflected in the W-2 and no amount is added to the stock's basis. The taxpayer must report the stock's sale on Form 1040, Schedule D, *Capital Gains and Losses,* in the year of sale. The gain or loss recognized is the difference between the selling price and the stock's basis. If the stock is immediately sold, there will be no gain even though the sale is reported on Schedule D. Because the discount is included in wages, that portion of gain has been taxed at ordinary rates and added to basis such that basis is equal to FMV at date of exercise. However, the amount included in wages as ordinary income is not subject to payroll taxes. If the stock is sold for more than the option price plus the discount, this additional gain is taxed as a capital gain.

> **Example 1.** The ESPP of Mellem Corporation grants John the right to buy company stock at a 15% discount on June 1, 2005. On the grant date, the option price is $85 and the FMV is $100. One year later, John exercises the option. On June 1, 2009, John sells the stock for $150 per share. In 2009, John's Form W-2 includes the $15 discount in W-2 income. Therefore, the basis of the stock sold is $100 ($85 + $15). The $50 gain ($150 – $100) is a capital gain.

If the ESPP stock option is exercised after the death of the employee, the employee's Form W-2 in the year of death includes the income from the discount. However, the basis of the stock is **not** increased by the W-2 income. Rather, the basis of the exercised stock is determined under the rules for inheritance. This is normally the FMV of the stock at the date of death.

> **Example 2.** The ESPP of Mellem Corporation grants John the right to buy company stock at a 15% discount on June 1, 2005. On the grant date, the option price is $85 and the FMV is $100. One year later, John's heir exercises the option just after John's death. John's W-2 is increased by the $15 discount. However, the basis of the stock is not increased by $15. The basis is determined by the inheritance rules of IRC §1014 (discussed later).

Nonqualified Stock Options. Nonqualified stock options are different than ESPP stock options. Nonqualified stock options must be included in income when the option is exercised. The basis of stock acquired through a nonqualified stock option is the exercise price of the stock plus the difference between the exercise price and the FMV at the date of exercise. Unlike the ESPP, the difference included in income is subject to payroll taxes.

> **Example 3.** Mary Corporation issues Jill nonqualified stock options. Jill can purchase company stock at a 15% discount. Jill exercises the option and pays $85 when the FMV of the stock is $100 per share. Jill's Form W-2 shows the $15 discount as both compensation and FICA and Medicare wages. Jill's basis is $100 per share.

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1. IRC §423(c).

Restricted Stock Options. Some companies award to employees stock that is subject to restrictions. The stock may be an outright gift or a purchase at an option price. The unique feature of the restricted stock option is that the employee does not recognize income until the restriction is removed (the stock is vested). If there is no outright cost of the stock to the employee, there is no basis until the stock is vested. At that time, the basis becomes the amount reported as compensation, which is the FMV of the stock. If there is an actual cost of the stock, the cost is included in the basis.

An election can be made when an employee is awarded the restricted stock option. This election allows the stock's FMV to be included in income at the time the option is awarded rather than when the stock is vested.[2] The election may allow the employee to minimize ordinary income and cause a larger amount to be subject to capital gains treatment. The election must be made by filing a statement with the IRS no later than 30 days after the date the stock is transferred to the employee.

Example 4. Tim Corporation awards a restricted stock option for 10,000 shares of company stock to employee Reggie on June 1, 2007, when the stock is valued at $1 per share. Fifty percent of the stock is vested on June 1, 2008, when the FMV is $3 per share and the remaining 50% is vested on June 1, 2009, when the FMV is $15 per share. At the time of the award, Reggie believes the stock will increase in value over the 2-year period. Therefore, he makes the §83(b) election and reports $10,000 in compensation in 2007. Reggie's basis in the stock is $10,000. At the end of the 2-year period, Reggie sells the stock for $150,000. Reggie reports a $140,000 gain ($150,000 – $10,000) on Schedule D. Had Reggie not made the §83(b) election, he would have included $15,000 in compensation ($3/share × 5,000 shares) in 2008 and $75,000 ($15/share × 5,000 shares) in 2009 for a total of $90,000 ordinary income. He would report a long-term capital gain of $60,000 ($150,000 – $90,000) on Schedule D.

Incentive Stock Options. Another type of stock acquisition is the incentive stock option (ISO).[3] An ISO is an option to purchase stock at a reduced rate. Generally, this is available to an executive. The difference between the stock's option price and the FMV at the time of exercise is not taxable. If the stock is held the required amount of time (at least two years from the granting of the option and at least one year after the stock is purchased), all gain at disposition receives long-term capital gain treatment. Unlike the other options, there is no ordinary gain included in income at the time of exercise.

Example 5. Jennifer is granted an ISO to purchase shares at $4 from her employer on December 24, 2007. She exercises the option on July 5, 2008, and sells the stock on December 31, 2009. Because she held the stock more than two years from the time the option was granted and more than one year from the time of purchase, she receives capital gain treatment on the sale.

Example 6. The stock described in **Example 5** had an FMV of $4 on December 24, 2007, $10 on July 5, 2008, and $23 on December 31, 2009. Jennifer recognizes a capital gain of $19 ($23 – $4) because she has no basis in the stock.

Example 7. Jennifer from **Example 5** sold the stock on July 31, 2009, for $23 rather than on December 31, 2009. She has not met the 2-year holding period requirement. Consequently, she recognizes ordinary wage income limited to the lesser of:

- $6 (FMV on the exercise date ($10) minus the adjusted basis (option price $4)), or
- $19 (sale price ($23) minus the adjusted basis ($4)).

The remaining gain of $13 ($19 – $6) is a capital gain.

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2. IRC §83(b).

3. IRC §422.

While the basis of the ISO is the option price, ISOs have a complication. This is the effect of the alternative minimum tax (AMT). If an ISO is exercised and held long enough to receive the full benefit of capital gain treatment, there is an AMT adjustment. The AMT adjustment is the difference between the option price and the FMV on the date of exercise. The AMT adjustment increases the basis of the stock for AMT purposes. This means the stock has two bases: a basis for regular tax purposes (the option price) and a basis for AMT purposes (option price plus AMT adjustment).

Example 8. Using the information from **Example 6,** Jennifer's stock has an AMT adjustment of $6 ($10 – $4) and an AMT basis of $10 ($4 + $6).

An ISO that is exercised and sold in the same year or within the disqualification period does not have two bases. The disqualified disposition results in income included on the Form W-2 in the same manner as a nonqualified stock option. The basis of an ISO that is disposed of during the disqualification period is the FMV on the date of exercise.

Mergers and Acquisitions

Corporate mergers and acquisitions affect the stock's basis. Many companies provide shareholders with worksheets to calculate gain and the resulting basis of the applicable shares. For example, consider the basis calculations required from the AT&T divestiture that occurred many years ago.

Wash Sales

Wash sales also affect stock basis. A wash sale is a sale of stock that resulted in a loss with a substantially identical stock purchased within 30 days before or after the sale.[4] The wash sale rules deny the recognition of a loss on the sale. Sales that result in a gain are not affected by the wash sale rules. The basis of stock affected by the wash sale rules is increased by the disallowed loss. The calculation is relatively simple when only one sale and one repurchase are involved. When there are multiple transactions involving the same stock, an ordering rule must be followed beginning with the oldest purchase within the 30 days prior to the sale. If the taxpayer has more than one repurchase within the timeframe, the disallowed loss is applied following first-in-first-out accounting (FIFO) in which the loss is first applied to the first repurchase and then to the second, etc.

Example 9. Martha purchased 300 shares of Pepsi stock for $3,000. She sells the Pepsi stock for $2,100 on July 3. She repurchases 300 shares of Pepsi stock on July 10 for $1,500. Since the repurchase is within 30 days before or after the sale date (July 3), Martha cannot claim the $900 loss. Martha's basis in the new shares is $2,400 ($1,500 cost + $900 disallowed wash sale loss).

Example 10. Martha purchased 300 shares of Pepsi stock for $3,000. She sells the Pepsi stock for $2,100 on July 3 resulting in a $900 realized loss. She repurchases 100 shares of Pepsi stock on July 10 for $800 and does not buy any other shares of Pepsi stock. Since the repurchase is within 30 days before or after the sale date (July 3), Martha cannot recognize the $300 loss related to the 100 shares repurchased, but can recognize the $600 loss on the 200 shares sold and not repurchased. Her basis in the 100 shares is $1,100 ($800 cost + $300 disallowed wash sale loss).

The taxpayer's holding period for the repurchased stocks or securities created by the wash sale rules includes the holding period of the stocks or securities sold.

Example 11. Fran purchased 500 shares of GM stock on February 17, 2009. She sold the shares at a $1,090 loss on March 9, 2009. Fran repurchased 500 shares of GM stock on April 1, 2009. Her loss is disallowed due to the wash sale rules. Fran's basis in the repurchased GM stock is her cost plus the $1,090 disallowed wash sale loss. Her holding period for the repurchased GM stock is the time she holds the repurchased stock plus the 42 days (February 17–April 1) she held the "washed" GM stock.

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4. IRC §1091.

A sale that is subject to the wash sale rules must be reported. The actual sales price and basis is shown as if it was a normal sale. The words "Wash Sale" should be noted so the IRS knows why the loss is not deducted. Listing the actual loss and then entering another "sale" with the description "Wash Sale" and a gain (no sales price or adjusted basis) equal to the disallowed loss is one way to show the loss was not allowed. A portion of a Schedule D showing a wash sale is shown below.

Part II Long-Term Capital Gains and Losses — Assets Held More Than One Year

	(a) Description of property (Example: 100 shares XYZ Co)	(b) Date acquired (Mo, day, yr)	(c) Date sold (Mo, day, yr)	(d) Sales price (see instructions)	(e) Cost or other basis (see instructions)	(f) Gain or (loss) Subtract (e) from (d)
8	500 GM	2/17/09	3/9/09	2,910	4,000	-1,090
	WASH SALE					1,090
9	Enter your long-term totals, if any, from Schedule D-1, line 9. . . .		9			
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d).		10	2,910		

The taxpayer should keep the records showing the adjusted basis of the stocks or securities sold, the sales documents for the stocks or securities sold, and the tax return for the year of the wash sale along with the cost of the repurchased stocks or securities. All of these items are required when the repurchased stocks or securities are sold.

Stocks or securities are always deemed to be substantially identical to themselves (e.g., AT&T common stock is substantially identical to other shares of AT&T common stock). Options and contracts to buy substantially identical stocks or securities are considered the same as the stocks or securities. Convertible bonds and preferred stock are not normally considered substantially identical to the common stock of the same corporation, although if they are converted to common stock within the 61-day window (30 days before and after the sale), the conversion may trigger the wash sale loss rules.[5] However, convertible preferred stock with similarities to the common stock may be considered identical.[6]

The wash sale rules do not apply to commodity futures contracts. Bonds with differences in interest rates and maturity dates are not identical and are exempt from the wash sale rules.[7]

The wash sale rules apply when the sale involves related parties such as a taxpayer with a sale and the taxpayer's spouse with the repurchase.[8] Controlled trusts also fall into the related-party provisions.[9]

MUTUAL FUNDS

Many taxpayers own mutual funds. The primary rule for determining the basis of an interest in a mutual fund is the same as determining the basis of a single share of stock. The typical mutual fund reports dividends and capital gains to the investor each year on a Form 1099-DIV. However, many investors do not receive these proceeds in cash but rather reinvest them into additional shares of the fund. This increases the number of shares owned, but the additional shares have a different basis than the original purchased shares. Unfortunately, many investors hold mutual funds for many years and do not track the basis of the fund shares.

5. Rev. Rul. 56-406, 1956-2 CB 523.

6. Rev. Rul. 77-201, 1977-1 CB 250.

7. *Helvering v. Campbell*, 313 U.S. 15 (Mar. 6, 1941).

8. *J.P. McWilliams v. Comm'r*, 67 S.Ct. 1477 (June 16, 1947).

9. *Security First National Bank of Los Angeles*, 28 BTA 289 (June 6, 1933).

The IRS allows a simplified method of tracking the fund basis that is available only for mutual funds. This method is known as the "average cost method." The average cost method has two variations: a **single-category** method and a **double-category** method. These are contrasted from the specific identification method and the first-in-first-out (FIFO) method of determining which shares of stock or mutual funds are sold.

This election should be chosen carefully because using either of the averaging methods for a particular mutual fund requires the use of that method for that specific fund as long as the taxpayer owns any shares in the fund.

Using either averaging method for a specific mutual fund does **not** have any effect on any other mutual fund.

Single-Category Method

The **single-category** averaging method computes the basis in a share of the mutual fund by dividing the total cost or other basis of the shares by the number of shares owned. The first shares sold are the first ones acquired (FIFO method) for purposes of determining the holding period for long-term or short-term treatment.

Example 12. Richard purchased ACE mutual fund shares five times over the past five years as described below:

Date	Shares	Price	Cost/Share
September 10, 2004 purchase	100	$ 2,500	$25
December 31, 2004 reinvestment	1	27	27
August 15, 2005 purchase	100	2,100	21
December 31, 2005 reinvestment	2	56	28
August 3, 2006 purchase	100	2,200	22
December 31, 2006 reinvestment	3	60	20
October 5, 2007 purchase	100	2,400	24
December 31, 2007 reinvestment	4	100	25
September 12, 2008 purchase	100	2,800	28
December 31, 2008 reinvestment	5	120	24
Total	515	$12,363	$24.01

Richard sold 300 shares on June 2, 2009, at $25 per share for $7,500.

Result Using FIFO. Using the default rule of FIFO, Richard's cost of these 300 shares is a total of $6,817 ($2,500 + 27 + 2,100 + 56 + (97 × 22)), resulting in a long-term gain of $683 ($7,500 – $6,817).

Result Using Single-Category Averaging. The result if Richard elects to use the single-category averaging method is different. Using this method, the average cost of his entire purchase is computed as $24.01/share ($12,363 ÷ 515 shares). This gives him a basis of $7,203 (300 × $24.01) for a net gain of $297 ($7,500 – $7,203).

For purposes of determining the holding period, Richard is deemed to have sold the shares purchased on September 10, 2004, December 31, 2004, August 15, 2005, December 31, 2005, and August 3, 2006 (the first 300 shares purchased). These dates all qualify for long-term treatment. Therefore, Richard has a $297 long-term capital gain. Richard's carryover basis is $5,160 ($12,363 – $7,203). The "purchase" dates of these carryover shares are:

Date	Shares	Price	Cost/Share
August 3, 2006 (remaining purchased shares)	3	$ 66	$22
December 31, 2006 reinvestment	3	60	20
October 5, 2007 purchase	100	2,400	24
December 31, 2007 reinvestment	4	100	25
September 12, 2008 purchase	100	2,800	28
December 31, 2008 reinvestment	5	120	24
Total	215	$5,546	$25.80

Double-Category Method

The **double-category** averaging method separates the shares into two categories: long-term and short-term. The share price within each category is averaged by dividing the number of shares within that category by the total costs of the shares in that category. The shareholder can choose to sell either long-term or short-term shares by using the specific identification method mentioned earlier. If the shareholder does not specify long-term or short-term shares, the default method is the FIFO method of selling the first shares first.

Example 13. Use the same information as **Example 12,** except Richard elects to use the double-category averaging method. The average cost of his long-term shares is $23.030/share ($9,443 ÷ 410 shares). The average of his short-term shares is $27.81/share ($2,920 ÷ 105 shares).

He further elects to sell shares from the short-term category first. Therefore, he sells the shares purchased on September 12, 2008, and December 31, 2008. This results in a **short-term loss of $295** ((105 × $25) – (105 × $27.81)). Because that constitutes all the short-term shares, he then sells 195 (300 – 105) long-term shares for the balance of the sale. This includes all the shares purchased on September 10, 2004, December 31, 2004, and 94 shares purchased on August 15, 2005. Richard's **long-term gain is $384** ((195 × $25) – (195 × $23.03)). Richard's carryover basis is $4,952 ($9,443 – (195 × $23.03)). When the next share(s) are sold, this is the basis that is used for the computation of the averaging, assuming no additional shares are acquired.

Date	Shares	Price	Cost/Share
September 10, 2004 purchase	100	$ 2,500	$25
December 31, 2004 reinvestment	1	27	27
August 15, 2005 purchase	100	2,100	21
December 31, 2005 reinvestment	2	56	28
August 3, 2006 purchase	100	2,200	22
December 31, 2006 reinvestment	3	60	20
October 5, 2007 purchase	100	2,400	24
December 31, 2007 reinvestment	4	100	25
Total long-term	**410**	**$ 9,443**	**$23.03**
September 12, 2008 purchase	100	2,800	28
December 31, 2008 reinvestment	5	120	24
Total short-term	**105**	**$ 2,920**	**$27.81**
Total	**515**	**$12,363**	**$24.01**

The election to use either averaging method is made by attaching a statement to a timely-filed tax return for the year the election is first effective. The election must be made by the due date, plus extensions. However, Treas. Reg. §301.9100-2 provides taxpayers an automatic 6-month extension from the unextended due date of the taxpayer's tax return for making this election.

The election should refer to Treas. Reg. §1.1012-1(e) and identify the method used (single- or double-category) and the fund name it applies to, such as:

Mutual Fund Basis Election

Taxpayer hereby elects under Treas. Reg. §1.1012-1(e) to adopt the **[single-category OR double-category]** method for computing basis in shares of **[name of fund]**, a regulated investment company. The shares have been purchased at different times.

> **Note.** Beginning in 2011, the average cost method of determining basis is extended to include specific stocks acquired through a dividend reinvestment plan.[10] A dividend reinvestment plan is any arrangement under which dividends are reinvested in identical stock. The initial stock purchased is also treated as acquired in connection with the plan, thus allowing averaging of its basis.[11] The stock using an average cost method acquired before January 1, 2012, is treated as a separate account from any such stock acquired on or after that date.
>
> The new rules were written to help brokers determine basis, because they must report the basis of stocks sold beginning in 2012.

REAL PROPERTY

Real property, held as an investment rather than business property, may take many forms. It may even include unimproved land, timber, and vacation homes. To determine the basis of land, the taxpayer must know how the land was acquired. Assuming it is an outright purchase, the basis is the cost of the land plus any acquisition costs. The following list of acquisition costs are added to the basis of the land.

Basis Adjustments from Purchase or Improvements

- Abstract or title search
- Document preparation
- Excavating costs
- Legal expense
- Buyer-paid points
- Recording fees
- Survey fees
- Transfer taxes
- Title insurance
- Utility installation

Buyer-Paid Expenses of Seller

- Real estate taxes
- Interest in arrears
- Other expenses
- Improvement costs

Generally, real estate taxes and interest do not increase the basis of real property. However, Treas. Reg. §1.266-1(b)(1)(i) contains an election which may be made to increase the basis of unimproved real estate by the carrying costs. Carrying costs include real estate taxes, mortgage interest, and flood or liability insurance. The term "carrying costs" is not defined in the code or regulations. However, the examples in the regulations use real estate taxes and interest. Rev. Rul. 56-264 adds insurance to that list but warns that carrying costs are only those items which would otherwise be deductible and not allocable to a capital account. Rev. Rul. 71-475 specifically denies "the cost of maintenance and upkeep" as carrying costs.

According to Rev. Proc. 79-24, unimproved real property is defined as land without significant buildings, structures, or any other improvements that contribute to its value.

The election under IRC §266 is made by attaching a statement to the original return for the year indicating the item or items covered by the election. The election with regard to unimproved real property is a **yearly** election.

10. IRC §§1012(c) and (d).

11. IRC §1012(d).

The regulations extend this election to improved real property and personal property but only during the construction period. It differs from the unimproved property election in that once made, it extends through the construction period.[12]

Capitalization of Carrying Costs for Unimproved Real Property Election

Taxpayer hereby elects under Treas. Reg. §1.266(b)(1) to capitalize the following costs for the tax year:

- Interest
- Real estate taxes
- Insurance

Timber

Timber can be held for sale as a business or as an investment. For a new forest, the basis of timber is the cost of the original trees that were planted. For land purchased with existing trees, an allocation of the purchase price is made between the land and the timber. The value of the timber should be made by a qualified appraiser when the property is purchased. If the land is acquired by gift or inheritance, an appraisal is still necessary to determine the allocation.

Once the beginning basis is determined, the timber basis is increased by direct costs incurred in reforestation.

Reforestation costs include site preparation costs such as brush, weed, and rodent control. The cost of seed and seedlings is also included. Labor, tools, and the depreciation of the equipment used in the process are also included.

Special rules exist allowing an election to deduct certain reforestation expenses rather than including them in basis. The election is made on Form T, *Timber*, Part IV, if applicable, or by attaching a statement to the return if Form T is not used.

Note. A discussion of the sale and production of timber is found in the 2003 *University of Illinois Federal Tax Workbook* in Chapter 6 beginning on page 231. This chapter can be found on the University of Illinois Tax School website **www.TaxSchool.illinois.edu/taxbookarchive.**

Vacation Property

The basis of a vacation home is calculated in the same manner as any other real estate. The initial basis is the cost of the property if purchased by the taxpayer. If the vacation home was acquired through a gift or inheritance, the basis is determined by the rules of gifts and inheritance (discussed later). The basis is increased by the cost of any improvements. If this property is used as a vacation rental, any depreciation allowed or allowable reduces the basis. Another consideration when calculating the basis is the effect of any casualty loss. The basis is reduced by the insurance proceeds collected and any loss recognized. The basis is increased by the amount spent to return the property to its original condition.

12. Treas. Reg. §1.266-1(b)(1)(ii).

Example 14. Steve and Ann purchased a vacation home several years ago for $75,000. They added a deck and upgraded the property for an additional $50,000. In 2008, their property was located in a federally-declared disaster area and incurred a casualty loss of $100,000 (difference between FMV of property before and after casualty but limited to the basis of the property). The insurance company reimbursed $65,000, leaving the taxpayers with a $35,000 casualty loss deduction. The taxpayers spent $80,000 to restore the home. In 2009, they installed a geothermal heat pump system at a cost of $6,000. The energy credit they realized was $1,800. The current basis of the property is calculated as follows.

Any energy improvements made to a personal residence that is not a principal residence (a vacation home) that are eligible for an energy credit increase the basis of the property. However, the basis must be reduced by any energy credits received.

Original cost	$ 75,000
Improvements	50,000
Insurance reimbursement	(65,000)
Personal casualty expense	(35,000)
Additional improvements in 2008	80,000
Geothermal heat pump	6,000
IRC §25D credit	(1,800)
Adjusted basis	$109,200

If a vacation home becomes a vacation rental, the basis for depreciation must be determined by comparing the adjusted basis as computed in the example above with the FMV at the time of conversion. **The basis for depreciation is the lower of adjusted basis or FMV.** If this property is later sold, the basis for sale purposes depends on whether the property is sold at a gain or a loss.

Example 15. Steve and Ann from **Example 14** decide to rent their vacation home during the winter. The property is located in a quiet area of Florida. Since the downturn in the economy, property values have fallen. The adjusted basis is $109,200 but the FMV is only $90,000 at the time they decide to rent the property. The basis for depreciation is $90,000. If they later sell the house for $135,000, the basis for sale is $109,200 less any current adjustments. If they sell for $85,000, the basis for the sale is $90,000.

LIKE-KIND EXCHANGE

Basis of Property Received in Exchange and Depreciation

The basis of property received in an IRC §1031 exchange is determined by looking at both the relinquished and replacement property. It is important to understand the definition of terms when calculating the basis.

- **Replacement property** is the property the taxpayer receives as a result of the exchange or conversion.
- **Relinquished property** is the property the taxpayer gave up as a result of the exchange or conversion.
- **Exchanged basis** is the adjusted basis of the relinquished property at the time of its disposition. This is determined after the current year's depreciation allowance, if any.
- **Excess basis** is the amount, if any, of cash or nonlike-kind property paid for the replacement property. This is commonly called "boot paid."

The basis of the replacement property is the adjusted basis (unrecovered cost) of the relinquished property plus boot paid. Unlike an outright purchase, the depreciation rules for the replacement property can be complex.

Note. For a detailed discussion of these rules, see the 2007 *University of Illinois Federal Tax Workbook*, Chapter 4, Like-Kind Exchanges, beginning on page 135. This chapter can be found on the accompanying CD.

BUSINESS PROPERTY

PURCHASED PROPERTY

The basis of property purchased for use in a business is the acquisition cost of the property. Any sales tax, transportation costs, and installation costs paid increase the basis of the property.

CONVERTED FROM/TO PERSONAL PROPERTY

Personal property that is converted to business property is subject to a slightly different rule. The basis for depreciation is the **lesser** of the cost or the FMV on the date of conversion. It is important to keep a record of both the cost and FMV in the event of a disposition of the property. Upon disposition by sale, the basis depends on whether the sale results in a gain or loss. If the property is sold at a gain, the basis is the current adjusted basis. If the property is sold at a loss, the FMV at the time of conversion is used to determine the loss. These rules prevent a taxpayer from creating a tax advantage by converting property.

If business property is converted to personal, the type of entity holding the business property can make a difference in the treatment. The conversion of property held by a sole proprietorship from business use to personal use causes the basis to be the same in the hands of the taxpayer as it was in the hands of the business. If the property is later sold, the depreciation claimed while it was business property must be taken into consideration in the same manner as if it was still owned by the business. If the property is sold at a gain, the depreciation is recaptured as ordinary income as it is with IRC §1245 property.

The conversion of property from business use to personal use can result in an increase in basis. In a situation in which property has either been expensed under IRC §179 or is listed property which was depreciated with or without expensing, the business recognizes a recapture amount if the property's business use decreases to 50% or less. The recapture is computed and reported on Form 4797, Part IV, *Sales of Business Property*. However, the effect of the recapture on the converted property's basis is to restore the basis of the property by the amount of depreciation or expensing that is recaptured.

Example 16. ABC Tax Professionals, a sole proprietorship operating out of a retail location, replaces one of its computers. The upgrade was necessary for business purposes but the computer was still usable. Joe, the owner, took the computer home in 2009. In doing so, the computer's business use dropped from 100% to 0%. Joe had expensed the computer and must now report the decreased use on Form 4797, Part IV, and recapture a portion of the §179 deduction claimed. Joe paid $1,000 for the computer and expensed it in 2007. If the computer had not been expensed, Joe would have been allowed depreciation under MACRS for 2007 and 2008. In 2009, the depreciation would be based on the business-use percentage, taking the conversion into consideration. If Joe bought the new computer in July, the final year use would be 50% business, 50% personal.

The depreciation for 2007, 2008, and 2009 was $601. The recapture amount was $399 ($1,000 – $601). Joe's adjusted basis in the computer is $399 ($0 + $399). Had Joe not expensed the computer, his adjusted basis in 2009 would have been the same amount. The expensing only created a timing difference.

2007 depreciation	$200
2008 depreciation	320
2009 depreciation ($192 ÷ 2)	81
Total depreciation	$601

If the property was owned by a corporation (C or S), the property would be treated as sold at FMV at the corporate level. The gain/loss would be recognized at the corporate level for the C corporation or as a pass-through by the shareholders of the S corporation. The property's basis to Joe would be the FMV used in the deemed sale.

Observation. The distribution of the computer to Joe would be treated as a dividend (C corporation) or distribution (S corporation).

Example 17. Use the same facts as **Example 16,** except the FMV of the computer must be determined. If the FMV is $300, the corporation realizes a gain of $300. The basis of the computer to Joe, the shareholder, is $300.

If the corporation chose to depreciate the computer rather than expense it, the adjusted basis of the computer at the time of the deemed sale is $399. The corporation realizes, but does not recognize, a loss of $99 ($300 – $399). Because the corporation is not liquidating, the loss is not recognized. It is instead added to the basis of the computer. Under this scenario, Joe's basis is $399.

Partnership property converted to personal use is treated as a distribution to the partner. The general rule is that the property has the same basis in the hands of the partner as it has in the partnership. If the partner's basis is greater than the partnership's basis in the property, the partner's basis is decreased by the basis of the asset distributed and the partner steps into the shoes of the partnership. A detailed example is included in the Partnership discussion later in the chapter.

CONSTRUCTED PROPERTY

Property may be constructed by a business for one of two purposes. The property may be constructed for use in the business or it may be constructed for sale. In either case, the cost of the construction includes the raw materials used in the construction. It also includes the cost of labor, design, and building permits or license.

If property is constructed for resale, the provisions of IRC §263A must be considered. The basis of property constructed for resale includes not only the direct costs such as raw materials and labor, it also includes the indirect costs such as real estate taxes, insurance, administrative expenses, utility costs, and interest.

EFFECT OF IRC §179 AND OTHER DEPRECIATION PROVISIONS

The basis of business property is adjusted not only by depreciation and improvements to property, but also by the use of the IRC §179 deduction and bonus depreciation. The basis of business property, more aptly referred to as the adjusted basis, is reduced first by the amount of §179 claimed. It is next reduced by the amount of bonus depreciation claimed. Any basis remaining is eligible for depreciation. Certain business property not eligible for depreciation may be amortized. The amortization deduction reduces the basis in the same manner as depreciation.

CANCELLATION OF DEBT

Cancellation of debt can result in a basis adjustment to property. If a taxpayer excludes the income from the cancellation, the taxpayer may be required to reduce the basis of the property. IRC §108 contains an ordering rule in which various tax attributes are reduced in exchange for the exclusion of debt cancellation income. Basis is one of the last attributes reduced on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*. However, the taxpayer may elect to adjust the basis of depreciable property first. Because each situation is different and the election is not without a cost, the final result must be carefully evaluated.

Debt Forgiveness Issues Involving Business Property

In the case of the qualified **farm indebtedness** exception, the amount of nontaxable debt discharge **cannot exceed** the amount of tax attributes available. Qualified property for these two exceptions only includes property used in a trade or business or held for investment.

Example 18. Albert has qualified farm debt that is cancelled. The bank issues a Form 1099-C, *Cancellation of Debt,* related to the purchase of farm equipment. The amount of the debt cancelled is $120,000. Albert's tax attributes include NOL carryovers of $50,000. Albert has a $30,000 basis in his remaining qualified (farm) property and has a personal residence with FMV of $150,000. Albert is not insolvent, but the residence is not taken into consideration for determining insolvency for the qualified farm indebtedness exclusion. Therefore, Albert excludes $50,000 of debt forgiveness income because of the NOL and $30,000 because of the basis in qualified assets. He must include the remaining $40,000 in income as shown below:

Cancelled debt	$120,000
NOL carryover	(50,000)
Basis of qualified assets	(30,000)
Remaining cancelled debt	$ 40,000

Note. For a complete review of cancellation-of-debt income, nonrecognition of income rules, and reduction of tax attributes, see Chapter 13 of the 2008 *University of Illinois Federal Tax Workbook,* beginning on p. 481. This chapter can be found on the accompanying CD.

The taxpayer may make a special election to reduce the basis of the taxpayer's property, on Form 982, Part II, line 5, before reducing other attributes. The election applies only to the aggregate adjusted bases of **depreciable** property held by the taxpayer on the first day of the following taxable year. Any assets sold during the current year are not subject to basis reduction. If there are multiple properties subject to the basis reduction, IRC §1017 provides an order for the basis reduction.

The election must be made on the taxpayer's timely-filed return for the taxable year in which the discharge occurs. A late election (after the due date of the return) may only be made with the consent of the IRS. To request the consent, the taxpayer must:

1. File a statement making the election and a completed Form 982 with an amended return or claim for credit or refund, and
2. Establish reasonable cause for failing to make the election with the original return.

The election is revocable only with the consent of the IRS.

Note. A special automatic extension of six months from the due date (including extensions) exists for any election whose due date is the date of the taxpayer's timely-filed return. The automatic extension is exercised by writing the following statement at the top of the document: "Filed Pursuant to §301.9001-2." The late election under this provision is sent to the same address that the timely election would have been sent.

Example 19. Sherry received a Form 1099-C that reported $40,000 of qualified farm indebtedness. Her tax attributes include her home with a basis of $150,000, farm equipment with a basis of $25,000, and an NOL of $50,000. Since Sherry is not insolvent, she excludes the debt forgiveness income under the qualified farm indebtedness exception. The personal residence, except to the extent of business use, is not taken into consideration for this purpose. In addition, Sherry wishes to preserve her NOL for future use. She elects to reduce the basis of the farm equipment first. The election is shown on a completed Form 982 which appears on the following page.

Note. The taxpayer may have good reason to make the election relating to depreciable property. It may be to preserve the NOL for future use against the sale of the property whose basis has been reduced, or in anticipation of future income.

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, ZIP code, and telephone no. Equipment Dealer	1 Date canceled 07/12/2009 2 Amount of debt canceled $ 40000.00 3 Interest if included in box 2 $	OMB No. 1545-1424 2009 Form 1099-C	**Cancellation of Debt**
CREDITOR'S federal identification number 111-11-1111 — DEBTOR'S identification number 121-21-2121	4 Debt description		**Copy B** **For Debtor** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name Sherry Street address (including apt. no.) City, state, and ZIP code	5 Was borrower personally liable for repayment of the debt? ☒ Yes ☐ No		
Account number (see instructions)	6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

For Example 19

Form **982** (Rev. March 2009) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ **Attach this form to your income tax return.**

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return	Identifying number
Sherry	**121-21-2121**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case . . . ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . ☐
- c Discharge of qualified farm indebtedness . . . ☑
- d Discharge of qualified real property business indebtedness . . . ☐
- e Discharge of qualified principal residence indebtedness . . . ☐
- f Discharge of certain indebtedness of a qualified individual because of Midwestern disasters . . . ☐

2 Total amount of discharged indebtedness excluded from gross income. . . . **2** **40,000**

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?. . . ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property . . .	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property. . . .	5	**25,000**
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge . . .	6	**15,000**
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge . . .	8	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge . . .	9	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness.* . . .	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked* . . .	10b	
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5 . . .	11a	
b	Land used or held for use in a trade or business of farming . . .	11b	
c	Other property used or held for use in a trade or business, or for the production of income .	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge . .	13	

The asset basis reduction mentioned above is subject to the limitations described in §1017.

Under the IRC §108 exclusions for bankruptcy or insolvency, the reduction in basis of the taxpayer's assets is **limited** to the total bases of the taxpayer's property (including money) immediately after the discharge minus the total liabilities of the taxpayer immediately after the discharge.

By making an election to reduce the bases first, the taxpayer reduces only the bases of **depreciable** property. Depreciable property is property subject to an allowance for depreciation, but only if the basis reduction reduces the amount of depreciation or amortization allowed in future years, including the year immediately following the year of discharge. Once this election is made, the reduction in bases is limited to the total bases of the taxpayer's depreciable property, ignoring any liabilities.

Example 20. Tom has debt forgiveness of $70,000 excludable under the insolvency exception. His depreciable assets have a $100,000 basis, and $150,000 of debts remain after the discharge. Tom also has a $40,000 NOL. Without the election, Tom reduces his NOL to zero and has no basis reduction because his debts exceed the asset basis. (The total decrease of tax attributes equals $40,000.) With the election, Tom reduces basis to $30,000 ($100,000 – $70,000), but retains his NOL. (The total decrease of tax attributes equals $70,000.)

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, ZIP code, and telephone no.		1 Date canceled 07/12/2009	OMB No. 1545-1424	Cancellation of Debt
Equipment Dealer		2 Amount of debt canceled $ 70000.00	2009	
		3 Interest if included in box 2 $	Form 1099-C	
CREDITOR'S federal identification number 111-11-1111	DEBTOR'S identification number 232-32-3232	4 Debt description		**Copy B For Debtor** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name Tom				
Street address (including apt. no.)		5 Was borrower personally liable for repayment of the debt? ☒ Yes ☐ No		
City, state, and ZIP code				
Account number (see instructions)		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form **1099-C** (keep for your records) Department of the Treasury - Internal Revenue Service

The taxpayer can make an election to treat certain real property inventory described in §1221(1) as if it was "depreciable property" by checking the box on Form 982, line 3.

There are specific ordering rules for the bases reductions. The reductions are pro rata among all items in the particular group. The ordering is:

1. Real property used in a trade or business or held for investment, other than real property inventory, secured by the discharged debt immediately before its discharge
2. Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable secured by the discharged debt immediately before its discharge
3. Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, or real property inventory
4. Inventory, accounts receivable, notes receivable, and real property inventory
5. Property not used in a trade or business or held for investment

The property bases reductions affect property the taxpayer holds at the beginning of the year immediately after the year the debt discharge occurs.

Basis reductions reduce the amount of deprecation the taxpayer can claim in each of the future years. A taxpayer using MACRS calculates the amount of depreciation by dividing each year's depreciation rate by the total of the remaining years' rates.[13]

13. Treas. Reg. §1.168-2(d)(3).

Example 21. In 2007, Sam paid $20,000 for a 5-year asset that is depreciated under MACRS. In 2007 and 2008, Sam claimed 20% and 32% of the cost, respectively, as his MACRS deductions. In 2009, Sam has $2,000 of basis reduction for this asset as a result of debt discharge. His depreciation calculations for the remaining life of this computer follow:

Cost		$20,000
Depreciation:		
2007	$ 4,000	
2008	6,400	
	$10,400	(10,400)
Remaining basis before debt discharge		$ 9,600
Basis reduction for debt discharge		(2,000)
Adjusted basis after discharge		$ 7,600

Year	Normal Depreciation Rate
2009	19.20%
2010	11.52%
2011	11.52%
2012	5.76%
Total	48.00%

Year		Adjusted Depreciation Rates
2009	19.20% ÷ 48.00%	40.00%
2010	11.52% ÷ 48.00%	24.00%
2011	11.52% ÷ 48.00%	24.00%
2012	5.76% ÷ 48.00%	12.00%
Total		100.00%

Year		Depreciation for Future Years
2009	40.00% × $7,600	$3,040
2010	24.00% × $7,600	1,824
2011	24.00% × $7,600	1,824
2012	12.00% × $7,600	912
Total		$7,600

The reduction in basis due to the debt discharge is treated as accumulated depreciation if the property is eventually sold. Property, such as land, that does not fall into §1250 is treated as §1245 property when sold.

Note. For real-property indebtedness, the basis reduction only applies to depreciable real property.

Debt Forgiveness Issues Involving Student Loans

IRC §108(f) provides special rules for the exclusion of income resulting from the forgiveness of student loans.

The monies available to be loaned must have been provided by:

- The U.S. government or one of its agencies,
- A state government or political subdivision,
- A public benefit corporation exempt under §501(c)(3), or
- An educational institution that has an arrangement with one of the above organizations to provide loans for education in certain areas of need.

The debt forgiveness exception does not apply if the student or former student performs services for the benefit of the educational institution that lent the money. Forgiveness in these cases is compensation to the student.

Performance of services for businesses that agree to pay/loan the money to fund education and forgive the loan after completion of a certain time period generally results in compensation to the employee.

INSTALLMENT OBLIGATIONS

Installment obligations define basis in two ways:

- The basis of the property received through an installment sale, or
- The basis of the obligation itself.

An installment sale can involve the sale of an entire business or the sale of one item. If the installment obligation represents the sale of one item, the basis of the installment obligation is initially the basis of the underlying asset. As installment payments are received, the principal payments include both the recovery of basis and gain on the sale. The recovery portion reduces the basis in the contract. If the contract is paid off before the end of the term, the gain or loss is measured by the payment less the basis in the contract.

When a business is sold on the installment method, the buyer establishes basis in the new assets by allocating the sales price of the obligation among the assets received. There is an ordering rule to the allocation. The sale price is allocated using the FMV residual method. The order of allocation is as follows:

1. Cash or cash-like items,
2. Inventory,
3. Business assets proportionally, and
4. Goodwill, if there is any sales price remaining.

When an entire business is purchased, the IRS requires that a Form 8594, *Asset Acquisition Statement Under Section 1060*, be attached to both the buyer's and the seller's returns. This form allocates the items into six classes of assets. However, this form alone will not establish the basis of each individual asset. A breakdown of the classes is necessary to report the items correctly on the depreciation statement.

PROPERTY RECEIVED AT DEATH

GENERAL RULE

The basis of property received by inheritance normally has a basis equal to the property's FMV on the date of the decedent's death.[14] This is the same value that is reported on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*. Property can be valued using an alternate valuation date (discussed later).

> **Example 22.** Missy died October 13, 2009. Her son Mark inherited AT&T stock worth $100,000 on the date Missy died. Mark's basis in the AT&T stock is $100,000.

The general rule is that the beneficiary's basis of property that the decedent owned at the time of death gets a new basis equal to the property's FMV. This FMV is typically understood to be what a willing buyer would pay a willing seller. If the property was owned jointly with the beneficiary, only the percentage in the estate gets a step-up in its basis to the FMV. The portion owned by the joint owner does not receive a new basis.

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14. IRC §1014(a)(1).

Example 23. Mike and Maggie jointly own their principal residence and have an adjusted basis of $400,000. Mike died when the property had an FMV of $800,000. Maggie's basis in the property becomes $600,000 ($200,000 for Maggie's original half + $400,000 for the half inherited from Mike).

If the taxpayer lives in a community property state and the property is community property, generally the entire property receives a new basis.

Example 24. Kate and Dan live in a community property state and jointly own their principal residence as community property. They have an adjusted basis of $550,000 in the residence. Kate died when the property had an FMV of $1 million. Dan's basis in the property becomes $1 million.

If the FMV of the property is lower than the basis on the date of death, the basis of the **inherited** property is the FMV. This rule applies whether the property is located in a community or a noncommunity property state.

Example 25. As in **Example 24,** Kate and Dan live in a community property state and jointly own their principal residence as community property. They have an adjusted basis of $550,000 in the residence. Kate died when the property had an FMV of $500,000. Dan's basis in the property becomes $500,000.

A special twist to jointly-held property can occur because of the *Gallenstein* case. This case involved a husband who had purchased property prior to 1977 and titled the property in joint names. The wife had no income and did not contribute to the purchase of the property. The court ruled that 100% of the property was properly includable in Mr. Gallenstein's estate, giving Mrs. Gallenstein a step-up on the entire basis. Generally, jointly-held property only receives a step-up on 50% of the property unless subject to community property rules.[15]

Income in Respect of a Decedent

Certain property received as a result of death does not receive a stepped-up or stepped-down basis. This is referred to as income in respect of a decedent (IRD) property. Though not specifically defined in the Code, IRD is income that the decedent earned prior to death but had not received. The most common types of IRD are unpaid wages, commissions, pensions or IRAs, interest, dividends, annuity payments, and installment sale payments. IRD also includes medical savings accounts (MSA) or health savings accounts (HSA).

The basis of IRD property is zero. Unlike other property, it does not receive a step-up in basis to FMV at the date of death.

U.S. savings bonds are another example of IRD property. There is no step-up in basis, and the income is taxable to the recipient. Tax planning options allow the executor to elect to include U.S. savings bond interest on the decedent's final return. The election gives the heir an increased basis. Communication and good records are needed to properly report the income when the bonds are redeemed.

Property Subject to Alternate Valuation Date

The alternate valuation date is available to an estate whose overall value decreases on a date six months after the date of death. An election must be made to use the alternate valuation date. If made, the basis of the property is the FMV on the 6-month date. When an election has been made but property was sold prior to that date, the FMV on the date of sale becomes the basis. If the election is made, all property in the estate must be valued on the 6-month date. Additionally, the election can only be made if both the gross estate and the sum of the estate tax and the generation-skipping tax decrease. It is particularly important to know if the election was made. While it is easy to search for the historical basis of stock on a certain date to establish basis, an heir may not know that the alternate valuation date election was made, and may use the wrong basis.

15. *Gallenstein v. U.S.,* 975 F.2d 286, 70 AFTR 2d 92-6228 (Sep. 16, 1992).

LIFETIME TRANSFERS

GIFTS

The basis of property received as a gift is the donor's adjusted basis. Special rules add the gift tax paid to the basis of the property. The current rule apportions the amount of gift tax based on the appreciation of the property. In reality, the payment of gift tax is rare.

Unfortunately, the gift recipient may not think about a gifted asset's basis until the property is sold. At that point, determining the basis may be difficult.

LIFE ESTATES

Often a taxpayer gifts property to his children yet retains a partial ownership in the property. Often this ownership is a life estate. A life estate is the right to control certain aspects of the gifted property for the remainder of the taxpayer's life. Examples include the right to receive the dividends from gifted stock, the right to rents from a gifted rental property, or the right to live in gifted property until death. Life estate ownership rights terminate upon the death of the donor.

If the donor retains a life estate, he made a gift of a future interest. These gifts are not eligible for the annual gift tax exclusion ($13,000 for 2009).

When the taxpayer gifts the property but retains a life estate, the taxpayer is considered to have gifted only the remainder interest in the property. This requires a special calculation in order to determine the value of the gifted portion of the overall property.

The value of the remainder interest for gift tax purposes is the FMV of the property multiplied by the remainder factor found in Table S, a part of the IRC §7520 valuation tables. The donor uses the interest rate in effect for the month of the gift, and the taxpayer's age at the time of the gift. When the life estate is for two or more lives, the IRS has other tables that must be used to calculate the remainder ownership percentage.

The interest rates can be found on **www.irs.gov** by searching for "7520" (the donor uses the interest rate of 120% of the applicable federal mid-term rates). The following table shows the rates for the past few years.

IRC §7520 Interest Rates

Year	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.	Oct.	Nov.	Dec.
2009	2.4	2.0	2.4	2.6	2.4	2.8	3.4	3.4	3.4			
2008	4.4	4.2	3.6	3.4	3.2	3.8	4.2	4.2	4.2	3.8	3.6	3.4
2007	5.6	5.6	5.8	5.6	5.6	5.6	6.0	6.2	5.8	5.2	5.2	5.0
2006	5.4	5.2	5.4	5.6	5.8	6.0	6.0	6.2	6.0	5.8	5.6	5.8
2005	4.2	4.6	4.6	5.0	5.2	4.8	4.6	4.8	5.0	5.0	5.0	5.4
2004	4.2	4.2	4.0	3.8	3.8	4.6	5.0	4.8	4.6	4.4	4.2	4.2
2003	4.2	4.0	3.8	3.6	3.8	3.6	3.0	3.2	4.2	4.4	4.0	4.2
2002	5.4	5.6	5.4	5.6	6.0	5.8	5.6	5.2	4.6	4.2	3.6	4.0
2001	6.8	6.2	6.2	6.0	5.8	6.0	6.2	6.0	5.8	5.6	5.0	4.8
2000	7.4	8.0	8.2	8.0	7.8	8.0	8.0	7.6	7.6	7.4	7.2	7.0

Following is a sample of the S tables using a 5.6% interest rate for a 70-year-old taxpayer.

TABLE S
BASED ON LIFE TABLE 90CM
SINGLE LIFE REMAINDER FACTORS
[APPLICABLE AFTER APRIL 30, 1999, AND BEFORE MAY 1, 2009]
INTEREST RATE

AGE	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
65	.52512	.51121	.49782	.48495	.47255	.46062	.44912	.43805	.42738	.41709
66	.53835	.52461	.51137	.49862	.48634	.47449	.46307	.45206	.44143	.43118
67	.55174	.53818	.52511	.51250	.50034	.48860	.47727	.46633	.45576	.44556
68	.56524	.55188	.53899	.52654	.51452	.50291	.49168	.48083	.47034	.46020
69	.57882	.56568	.55299	.54071	.52885	.51737	.50627	.49552	.48513	.47506
70	.59242	.57951	.56703	.55495	.54325	.53193	.52096	.51034	.50004	.49007
71	.60598	.59332	.58106	.56918	.55767	.54651	.53569	.52520	.51503	.50516
72	.61948	.60707	.59504	.58338	.57206	.56108	.55043	.54009	.53004	.52029
73	.63287	.62073	.60895	.59751	.58640	.57561	.56513	.55495	.54505	.53543
74	.64621	.63435	.62282	.61162	.60073	.59015	.57985	.56984	.56009	.55061
75	.65953	.64796	.63671	.62575	.61510	.60473	.59463	.58480	.57523	.56591

Example 26. Grandpa Tom, age 70, makes a gift to his son Allan of a remainder interest in his personal residence in February 2007. The residence's FMV on the date of the gift is \$100,000 and its basis is \$40,000. The IRC §7520 interest rate is 5.6%. The remainder factor for age 70 and a 5.6% interest rate from Table S is .51034. Therefore, Grandpa Tom is deemed to have made a gift to Allan of a future interest of \$51,034 (\$100,000 × .51034). The adjusted basis in the gifted portion of the property is 51.034% of the total adjusted basis in the property. The adjusted basis of Allan's remainder interest is \$20,414 (\$40,000 × .51034).

As the taxpayer ages, the remainder factor increases and the life estate factor decreases. These are not important unless the property is sold prior to the taxpayer's death. When a sale takes place before the taxpayer's death, the percentage of the sale belonging to each owner (life estate owner and remainder owner) is calculated by using Table S for the rate applicable at the time of the **gift.** The original table is used, but the factors for each ownership change because the age of the life estate owner changes.[16]

Example 27. Use the same information as **Example 26,** except the property is sold when Grandpa Tom is age 75. The IRC §7520 interest rate when the gift took place was 5.6%; therefore, the S table for the 5.6% interest rate is still used. However, now Grandpa Tom is age 75 and the new remainder factor is .58480. Therefore, Allan is deemed to own 58.480% of the property upon its sale and Grandpa Tom is deemed to own the other 41.520%. Grandpa Tom reports 41.520% of the sales price, selling expenses, and adjusted basis. Allan reports 58.480% of the sales price, selling expenses, and adjusted basis.

It is unlikely the taxpayer will sell the life estate interest to anyone without the remainderman selling the remainder interest at the same time. A potential buyer of the life estate interest knows the interest is immediately terminated when the life estate owner dies. Therefore, the buyer has no idea about the length of time that the ownership rights will exist. As such, the buyer normally only purchases the property if both the life estate owner and the remainder owner sell their respective ownership.

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16. Treas. Reg. §1.014-5(a)(2).

When a taxpayer retains a life estate ownership in property and dies prior to the property's disposition, the taxpayer is considered to have enough control over the property to require its inclusion in the taxpayer's estate. Such an inclusion requires the full FMV of the property to go into the taxpayer's estate for estate tax purposes. In some states, this ownership does not apply unless the ownership is held in a trust, while in other states the wording "retained life estate" is sufficient to show the life estate ownership. When the property is included in the taxpayer's estate, the property is deemed to be inherited by the remainder owner(s). As inherited property, the basis to the remainder owner(s) is the property's FMV on the date of the decedent's death.

> **Example 28.** Grandpa Tom in **Example 27** dies years later when the property has an FMV of $130,000. The entire $130,000 is included in Grandpa Tom's estate and Allan's basis in the property is $130,000.

A life estate ownership can also be implied and demonstrated by the actions of the owner of record (recipient) and the taxpayer who transferred the property. For example, a life estate owner of real estate is normally responsible for the real estate taxes, insurance, and general upkeep of the property.

Sometimes a taxpayer who solely owns property will create a life estate that covers more than someone else's life. Commonly in a second-marriage situation, a taxpayer puts into his will the right for the spouse to live in the property until the spouse's death. Because the spouse is not the owner of the property when the life estate is created, the property's FMV on the date of the spouse's death is not an asset of the spouse for estate tax purposes. There is a uniform basis in the property that applies. This uniform basis is the FMV at the time of the taxpayer's death and does not change except by normal annual adjustments, such as improvements, depreciation, etc. The FMV at the time of the taxpayer's death is the basis used for both the life estate owner (spouse) and the remainder owners. The percentage belonging to each changes as the life estate owner gets older, but the uniform basis does not change. Because the value is not included in the spouse's estate upon the spouse's death, the property does **not** receive a new basis upon the spouse's death.

> **Example 29.** Gina died on January 19, 2007. Her will left her principal residence to her son Jason and also granted Gerald, her husband, a life estate in the property. The property had an FMV of $150,000 on the date of Gina's death. The IRC §7520 interest rate for January 2007 is 5.6%. Gerald and Jason jointly sell the property when Gerald is age 75. The life estate ownership is 41.520% and the remainder ownership is 58.480%. Therefore, Gerald reports 41.520% of the sales price, selling expenses, etc., and Jason reports the remaining 58.480%.

> **Example 30.** Use the same facts as **Example 29,** except Gerald dies prior to a sale of the property. In this case, Jason is now the 100% owner of the property. Jason has a basis in the property of $150,000 (100% of the FMV on the date of Gina's death — not Gerald's death — plus improvements, less depreciation, etc.).

TRUST PROPERTY

REVOCABLE TRUSTS

When a revocable trust is funded, property is generally retitled in the trust's name. However, the basis of the property contributed to the revocable trust retains the same basis. A brokerage account in the name of John Doe will not automatically become a brokerage account named the "Revocable Trust of John Doe" or "John Doe, Living Trust." If the asset is not formally transferred, it is generally not a part of the trust. There must be some proof that the taxpayer intended the asset to be a part of the trust although the asset was not formally transferred.

A revocable trust is ignored for tax purposes. Consequently, the basis of an asset transferred to or from the trust does not change. Because the assets are included in the estate tax return of the grantor at death, they do receive a step-up in basis to the FMV at the date of death.

IRREVOCABLE TRUSTS

Irrevocable trusts can be created while a taxpayer is living. Because the trust is irrevocable, the taxpayer is deemed to have made a gift of the assets to the trust and the basis of the assets transfer to the trust. The assets do not receive a step-up in basis when the grantor dies.

PARTNERSHIPS

CONTRIBUTED PARTNERSHIP PROPERTY

The partnership is deemed to step into the shoes of the partner with regard to property contributed to the partnership. The partnership assumes the basis, accumulated depreciation, recovery period, and depreciation method of the partner.

Property purchased by the partnership follows the same basis rules as previously discussed for business property.

BASIS IN LIQUIDATION

The basis of property received by a partner in a partnership dissolution is the basis of the partner's interest less any cash or cash-like assets received.[17] If the distribution is not part of a complete liquidation, the basis of the asset in the hands of the partner is the same as its basis in the hands of the partnership, assuming the partner has at least that much basis in her partnership interest.[18] If there are multiple assets, the partner's remaining basis is allocated between the assets in order to consider the appreciation or depreciation of the asset compared to its FMV. Assets that have declined in value are allocated the decrease to FMV. The remaining decrease is allocated based on the assets' bases after the decrease.

Example 31. Pam's basis in the liquidating partnership is $12,000. She receives $2,000 in cash and two parcels of land. The land has the following bases and FMV.

Property	Basis	FMV
A	$ 5,000	$ 8,000
B	10,000	6,000
Total	$15,000	$14,000

Pam first reduces the basis in her partnership interest by the cash received ($12,000 – $2,000 = $10,000). This becomes the basis she must allocate to the other assets she received. Because one asset (B) has a basis in the partnership that is higher than its FMV, Pam has a provisional basis in the asset of its FMV of $6,000. Pam's provisional basis in asset A is its partnership basis of $5,000. The total provisional basis of both assets is $11,000 ($6,000 + $5,000), leaving a remaining excess partnership basis of $1,000 ($10,000 – $11,000) to allocate. This excess basis reduces the provisional basis of the assets proportionally by their provisional bases. Asset A's provisional basis is reduced by $455 and Asset B's provisional basis is reduced by $545. Pam's basis in asset A is $4,545 and her basis in asset B is $5,455.

Property	Provisional Basis	Percentage	Basis Reduction	Pam's Basis
A	$ 5,000	$5,000 ÷ $11,000 = 45.5%	($455)	$4,545
B	6,000	$6,000 ÷ $11,000 = 54.5%	(545)	5,455
Total	$11,000			$10,000

17. Treas. Reg. §1.732-1(b).

18. IRC §732(b).

PARTNERSHIP INTEREST

A number of terms are used to describe a partner's basis. Two common terms are inside and outside basis. **Inside basis** is determined by the basis of the assets held by the partnership. Any transactions within the partnership — such as contributions, gains, losses, and deductions — affect the inside basis. On Form 1065, *U.S. Return of Partnership Income,* the partners' capital account plus the share of the partnership liabilities equals inside basis.

Outside basis is the partner's basis taking into consideration events or distributions that have affected the partner independently. It is necessary to know outside basis when determining the amount of partnership losses that are deductible. Outside basis is also used if a partnership interest is sold in order to determine the gain or loss on the sale. The inside and outside basis will only be equal if the partner is able to utilize all pass-through items from the partnership and obtained the partnership interest by contributing assets at the time the partnership was formed. If any of the following events happen, outside basis will differ from inside basis:

- There are excess distributions,
- Pass-through losses are limited due to the at-risk rules, or
- The interest was acquired other than by contribution of assets (for example, it was purchased from a prior partner or was inherited).

The outside basis of a partnership interest acquired by purchase from another partner begins with the amount paid. If the partnership interest is received by gift, the outside basis begins with the adjusted basis of the donor. In the case of inheritance, the outside basis is generally the FMV of the interest at the date of death or on the alternative valuation date if elected by the estate.

A partner's basis in the partnership includes the partner's investment plus the partner's share of the partnership's debts. The partner's at-risk amount is the same as the basis **except** the debts included for at-risk purposes include only recourse and qualified nonrecourse debts. The at-risk amount is used to limit a taxpayer's losses. Unfortunately, the at-risk amount is commonly referred to as the taxpayer's "basis" for simplification purposes.

The ordering rule for increases and decreases to the partner's basis under Treas. Reg. §1.704-1(d)(2) follows. The basis is:

- Increased by additional contributions to capital. For this purpose an increase in the partner's share of debts is an addition to basis.
- Increased by any income items passed through on the Schedule K-1, whether taxable or nontaxable. This includes ordinary income, interest income, net rental income, etc.
- Decreased by distributions. For this purpose, a decrease in the partner's share of debts is a distribution.
- Decreased by deductible losses and expenses, such as charitable contributions and §179 expense.
- Decreased by nondeductible expenses, such as 50% of meals and entertainment expenses.
- Decreased by the deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis.

A partner's outside basis can never be less than zero, but the capital account may be negative. If a distribution greater than the partner's outside basis is received, the partner must report the excess distribution as income. This is termed a "distribution in excess of basis." The excess is reported on Schedule D as either a long-term or short-term capital gain, depending on the holding period of the partnership interest. If a loss greater than the outside basis is passed through, the excess loss is suspended. The excess losses or deductions, otherwise known as at-risk losses/deductions, are used once the outside basis is increased above zero.

Example 32. Alan has a basis of $2,000 in the partnership at the beginning of 2008. The 2008 Schedule K-1 shows a loss from operations of $5,000. Alan is only allowed to deduct $2,000 of the loss. This results in his basis at the end of 2008 being $0. The remaining $3,000 ($5,000 – $2,000) is a suspended at-risk loss. This amount must be tracked because it will not be reported on the Schedule K-1 for 2009. This is the case even though it can be deducted in 2009 if Alan's basis increases. Form 6198, *At-Risk Limitations,* is used to determine if a taxpayer has adequate basis to deduct a loss.

Losses and deductions disallowed by basis limitations retain their character, such as ordinary or capital. Temp. Treas. Reg. §1.469-2T(d)(6) deals with the allocation of losses and deductions if they are not allowed due to basis limitations. Although this regulation is found in the passive activities portion of the regulations (§469), it addresses the allocation for a partner's distributive share of losses (§704) and pass-through losses to shareholders (§1366). The losses and deductions must be prorated by comparing the individual loss amounts to the total loss amounts. For example, if the total disallowed loss is $10,000 and the ordinary loss passed through represents 90% of the overall losses and deductions passed through, then $9,000 (90%) of the disallowed loss is an ordinary loss.

If there is a change in partners, the partnership is allowed to make an IRC §754 election. When this election is made for a partner, that particular partner's share of the partnership's assets are stepped-up for that partner only. The partnership does not change its assets on the balance sheet, but maintains a separate accounting of the adjustments that applies only to the partner affected by the election. The partnership passes through any specific adjustments relative to those assets, such as increased depreciation or adjustments on the sale of assets. These separate adjustments affect that partner's basis along with the normal Schedule K-1 pass-through items.

CORPORATIONS

PROPERTY CONTRIBUTED TO A CORPORATION

The basis of property contributed to a corporation is treated differently than the basis of property contributed to a partnership. There is no difference in treatment between a C corporation and an S corporation. The corporation basis is determined by the rules of IRC §362. If the contribution is part of a qualified §351 transfer, the property has the same basis as it had in the hands of the contributing shareholder.

If the transfer does not meet the requirements of §351, the transfer is deemed as a sale at FMV and the shareholder must recognize any gain. If gain is recognized, the FMV then becomes the basis of the property to the corporation. The shareholder's basis in the stock received is the FMV of the contributed property at the time it is received. If gain is not recognized, the basis of the contributed property becomes the basis of the stock received.

Shareholder's Basis in Distributed Property. Unlike a partnership, the shareholder's basis in the distributed property is the FMV of the property at the time of distribution. If the taxpayer also assumes a liability with the property, the taxpayer's basis is the greater of the FMV or the liability assumed.

Example 33. Hill, Inc., is liquidating. The only asset in the corporation is a machine subject to a liability. The machine's FMV is $12,000. The corporation still owes $18,000 on the machine. The sole shareholder receives both the machine and the liability. The corporation must report the sale of the machine at the higher of the property's FMV or the liability. In this case, the liability is higher. Therefore, a "sale price" of $18,000 must be reported by the corporation on the corporation tax return. The shareholder has an $18,000 basis in the machine. The shareholder will realize an $18,000 liquidating dividend.

SPECIAL RULES RELATED TO LIQUIDATION

Property contributed within two years of a corporate liquidation is subject to a special rule. For purposes of recognizing a loss by a liquidating corporation on the sale or distribution of property, the adjusted basis of the property is reduced, but not below zero, by the excess of the adjusted basis of the property immediately after acquisition less the property's FMV at that time.[19]

The corporation is prohibited from recognizing a loss on the property's disposition because the primary intent appears to be the transfer of the property to the corporation in order to offset the loss with other gains.

> **Example 34.** Tom, the sole shareholder of Tom's, Inc., decides to liquidate the corporation. Tom also owns a parcel of land that has lost value since its purchase. Tom decides to contribute the property to the corporation prior to liquidation in order to offset the gain of property he will receive in the liquidation. The land has an FMV of $35,000 and a basis of $75,000. Unfortunately, Tom's, Inc., cannot use the built-in loss of $40,000 to offset other gains from the corporate liquidation.

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S CORPORATION

When an S corporation requires additional cash, there is often a question about whether to make a capital contribution or a loan to the corporation. There are various issues to consider:

- Loans require repayment. Capital contributions do not require future distributions.
- Loans require interest payments. Capital contributions do not require interest payments.
- The current portion of loans must be repaid before the corporation can make distributions to the shareholder.
- If the corporation fails, loans have a higher priority and are required to be paid in full before shareholders receive distributions. For this purpose, a shareholder who makes a loan to the corporation has a right to the loan repayment before the same shareholder is entitled to any distributions. It places the shareholder in almost the same position as other creditors.
- Properly documented loan repayments are less likely to be challenged as distributions if the IRS attempts to recharacterize them as wages.

Consequently, S corporation shareholders can have two basis items to track: loan basis and stock basis.

Stock Basis

The initial basis of stock in an S corporation is the cash and adjusted basis of property contributed to the corporation. If the shareholder received the stock by inheritance, gift, or other means, the beginning basis is determined accordingly.

Treas. Reg. §1.1367-1(e) provides specific ordering rules for the adjustment of basis each year. Stock basis is:

1. Increased by additional contributions to capital.
2. Increased by any income items passed through on the Schedule K-1, whether taxable or nontaxable. This includes ordinary income, interest income, net rental income, etc.

> **Note.** Starting October 2001, nontaxable cancellation of indebtedness does not increase a shareholder's basis.

3. Decreased by distributions.
4. Decreased by nondeductible expenses, such as 50% of meals and entertainment expenses.
5. Decreased by deductible losses and expenses, such as charitable contributions and §179 expense.

19. IRC §336(d)(2)(A).

Stock basis can never be less than zero. Pass-through deductions in excess of stock basis are suspended. Distributions in excess of stock basis are taxable. Excess distributions are reported on Schedule D as long-term or short-term capital gains, depending on the holding period of the stock.

Example 35. In 2008, Brandon contributed $5,000 to BAB Corporation in exchange for 100% of the corporation's stock. The Schedule K-1 for 2008 shows a nonseparately-stated ordinary loss of $7,000 and nondeductible expenses of $500.

Brandon's basis is calculated as follows:

Beginning basis	$5,000
Nondeductible expenses	(500)
Subtotal	$4,500
Deductible loss	(4,500)
Ending basis	$ 0

The remaining $2,500 ($7,000 – $4,500) of deductible loss is carried over to 2009.

In 2009, Brandon made an additional contribution of $1,000 to BAB Corporation. The Schedule K-1 for 2009 shows nonseparately-stated ordinary income of $1,250 and nondeductible expenses of $500.

Brandon's basis is calculated as follows:

Beginning basis (from end of 2008)	$ 0
Additions to capital	1,000
Subtotal	$1,000
Income	1,250
Subtotal	$2,250
Nondeductible expenses	(500)
Subtotal	$1,750
Deductible suspended loss	(1,750)
Ending basis	$ 0

The remaining $750 ($2,500 – $1,750) of deductible loss is carried over to 2010.

The shareholder can make a formal election under Treas. Reg. §1.1367-1(f) to reduce the basis by the deductible losses and deductions before reducing the basis by nondeductible items. The election is made by attaching a statement to a timely-filed original or amended return. Once made, this election is irrevocable for that year and all future years.

Observation. A shareholder who is currently limited to losses due to at-risk rules must decide if it is better to carry over nondeductible expenses or deductible expenses to the following year. If the shareholder expects income increases, carrying the deductible expenses may produce a better result and the election should not be made.

Example 36. If Brandon from **Example 35** makes the Treas. Reg. §1.1367-1(f) election in 2008, his basis is calculated as follows:

Beginning basis	$5,000
Deductible losses	(5,000)
Subtotal	$ 0
Nondeductible expenses	(0)
Ending basis	$ 0

The remaining $2,000 ($7,000 – $5,000) of deductible loss is carried over to 2009, as well as the $500 of nondeductible expenses.

Beginning basis (from end of 2008)	$ 0
Additions to capital	1,000
Subtotal	$1,000
Income	1,250
Subtotal	$2,250
Deductible loss (carried from 2008)	(2,000)
Subtotal	$ 250
Nondeductible expense (carried from 2008, limited to basis)	(250)
Ending basis	$ 0

The remaining $750 of nondeductible expenses are carried to 2010.

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Temp. Treas. Reg. §1.469-2T(d)(6) deals with the allocation of losses and deductions if they are not allowed in total due to basis limitations. The losses and deductions must be prorated by comparing the individual amounts to the total of the amounts.

Example 37. Curtis invested $5,000 in an S corporation. His Schedule K-1 for the year shows $7,000 of nonseparately-stated ordinary loss, $1,000 of §1231 loss, and $500 of nondeductible expenses. The losses result in the following basis adjustments:

Beginning basis	$5,000
Nondeductible expenses	(500)
Subtotal	$4,500
Deductible loss	(4,500)
Ending basis	$ 0

Because the entire loss of $8,000 ($7,000 + $1,000) is not used, the amount used must be prorated between the nonseparately-stated ordinary loss and the §1231 loss. The amount of nonseparately-stated ordinary loss used is calculated by dividing the nonseparately-stated ordinary loss by the total losses and then multiplying by the deductible loss (($7,000 ÷ $8,000) × $4,500 = $3,938). The remainder of the $3,062 nonseparately-stated ordinary loss is carried forward ($7,000 – $3,938).

The amount of §1231 loss used is calculated by dividing the §1231 loss by the total losses and then multiplying by the deductible loss (($1,000 ÷ $8,000) × $4,500 = $562). The remainder of the $438 §1231 loss is carried forward ($1,000 – $562).

	Current Year Loss	Allowed Loss	Carryover Loss
Ordinary	$7,000	$3,938	$3,062
Section 1231	1,000	562	438
	$8,000	$4,500	$3,500

IRC §1244 stock losses are available if a shareholder has a loss from the disposition or liquidation of her entire interest in an S corporation. The §1244 treatment only applies to the original contribution made in exchange for the stock. Therefore, additional contributions of capital to the S corporation do not qualify for §1244 treatment unless new shares are issued each time contributions are made. Consequently, any additional stock basis, such as gains passed through on Schedule K-1, is not eligible for the §1244 stock treatment. The loss is required to be prorated between §1244 stock treatment and Schedule D treatment based on the investments.

Example 38. In 2008, Peter invested $5,000 in PT, Inc., an S corporation. His 2008 Schedule K-1 showed a $3,000 gain. This increased Peter's basis to $8,000 ($5,000 + $3,000).

Peter's 2009 Schedule K-1 in PT, Inc., showed $0 gain. The corporation liquidated and Peter received $4,000 in complete liquidation of his investment.

Peter has an investment of $8,000, of which $5,000 was an investment that qualified for §1244 treatment. His §1244 loss is $2,500 ($5,000 ÷ $8,000) × $4,000)). The remaining $1,500 ($4,000 – $2,500) loss is a Schedule D loss.

If stock basis is decreased due to losses or distributions, the availability of the §1244 treatment is limited to the remaining basis.[20]

Example 39. In 2008, Sylvia invested $5,000 in EP, Inc., an S corporation. During 2008, her Schedule K-1 showed a $4,000 loss. This reduced Sylvia's basis to $1,000.

In 2009, Sylvia's Schedule K-1 shows a $7,000 gain. This increases Sylvia's basis to $8,000.

At the end of 2009, EP, Inc., liquidated and Sylvia received $1,500. Sylvia has a $6,500 ($5,000 – $4,000 + $7,000 – $1,500) loss to report. Sylvia can only claim $1,000 as a §1244 loss because $4,000 of her **original** §1244 investment was eliminated with the loss from 2008.

Loan Basis

An S corporation shareholder only has basis in loans she makes directly to the S corporation. Unlike a partnership, an S corporation shareholder does not have a basis in any other S corporation loans.

Stock basis is always reduced first. Only after stock basis has been reduced to zero is loan basis reduced. The opposite occurs when basis is restored. Only after loan basis is restored to the full face amount still due on the loan is stock basis restored. An exception to this rule is discussed later.

The beginning basis of loans in an S corporation is the amount loaned to the corporation. Treas. Reg. §1.1367-1(e) is generally followed when adjusting loans except increases never create a loan basis greater than the balance due on the loan.

Loan basis is:

- Increased by any income items passed through on the Schedule K-1, whether taxable or nontaxable. This includes ordinary income, interest income, net rental income, etc.

> **Note.** Starting October 2001, nontaxable cancellation of indebtedness does not increase a shareholder's basis.

- Decreased by nondeductible expenses, such as 50% of meals and entertainment expenses.
- Decreased by deductible losses and expenses, such as charitable contributions, §179 expense, and ordinary losses.
- Decreased by loan repayments to the extent nontaxable.

20. IRC §1367(b)(3).

Each loan is deemed to be a separate loan as evidenced by their individual written contracts.

If there are no written loan documents, the total amount due is treated as a single loan. If a shareholder has more than one loan, each loan's basis is reduced by a pro-rata share of the total reduction. The pro-rata share is based on the remaining basis of each loan compared to the total bases of all loans.

Example 40. Carol loaned $5,000 to her S corporation in 2007. Her stock basis is zero. Her Schedule K-1 for 2007 shows $1,000 of nonseparately-stated ordinary loss. This reduces her loan basis to $4,000 ($5,000 – $1,000).

During 2008, Carol loaned an additional $6,000 to her S corporation. The loan had properly supported documentation. Her Schedule K-1 for 2008 shows a loss of $2,000. Her loan bases are reduced as follows:

	Amount Due	Basis
2007 Loan 1	$ 5,000	$ 5,000
2007 K-1 loss		(1,000)
Total	$ 5,000	$ 4,000
2008 Loan 2	6,000	6,000
Total	$11,000	$10,000
2008 Loss		(2,000)
Total		$ 8,000

		Loan 1		Loan 2
Basis		$4,000		$6,000
Reduction for 2008 loss	(($4,000 ÷ $10,000) × $2,000) =	(800)	(($6,000 ÷ $10,000) × $2,000) =	(1,200)
Basis end of 2008		$3,200		$4,800

The restoration of basis in the loans is pro rata based on the total reductions that have taken place among the outstanding loans.

Example 41. Use the same facts as **Example 40,** except Carol's Schedule K-1 for 2009 shows $1,000 of income. Her basis in the loans is increased as follows:

	Loan 1		Loan 2
2007 loss	$1,000		
2008 loss	800		$1,200
Total reductions	$1,800		$1,200
Loan basis at end of 2008	$3,200		$4,800
Restoration for 2009 gain			
(($1,800 ÷ ($1,800 + $1,200) × $1,000) =	600	(($1,200 ÷ ($1,800 + $1,200) × $1,000) =	400
Loan basis at end of 2009	$3,800		$5,200

The bases for both loans is $9,000 ($3,800 + $5,200).

An S corporation's repayment of a loan from the shareholder does not result in income to the shareholder (other than interest) if the loan basis was not reduced. However, if loan basis was reduced, the repayment of some or all of the loan results in income for the shareholder.

The nontaxable percentage of the repayment is determined by dividing the loan basis by the loan's unpaid balance, and then multiplying this percentage by the loan repayment.

Example 42. Donald loaned $5,000 to his S corporation in 2008. His stock basis is zero. His Schedule K-1 for 2008 shows $1,000 of nonseparately-stated ordinary loss. This reduces his loan basis to $4,000 ($5,000 – $1,000).

During 2009, the corporation repaid $2,000 of this loan. Donald's Schedule K-1 shows $0 income. Donald's nontaxable income from the repayment is calculated as follows:

($4,000 ÷ $5,000) × $2,000 = $1,600

The remaining $400 ($2,000 – $1,600) is taxable to Donald.

Note. If the S corporation repaid the entire $5,000, the equation would have resulted in $1,000 of taxable income, which equals the amount of the loss taken in 2008 using the loan basis.

If there is income in the year of the repayment, the income is first used to restore the loan basis before the calculation of any gain on the repayment.

Example 43. Arnold loaned $5,000 to his S corporation in 2007. His stock basis is zero. His Schedule K-1 for 2007 shows $1,000 of nonseparately-stated ordinary loss. This reduces his loan basis to $4,000.

During 2008, the corporation repaid $2,000 of this loan. Arnold's Schedule K-1 shows $500 of income for the year. Arnold's income from the repayment is calculated as follows:

Loan basis at end of 2007	$4,000
Increase for 2008	500
Loan basis at end of 2008	$4,500

Nontaxable income from repayment is $1,800 ($4,500 ÷ $5,000 × $2,000)

Taxable income from repayment is $200 ($2,000 – $1,800)

Loan basis carried to the following year is reduced by the nontaxable portion of repayment.

Example 44. Use the same facts as **Example 43,** except Arnold's loan basis carried to 2009 is $2,700. This is his former basis of $4,500 minus the $1,800 of nontaxable repayment. The outstanding loan balance is $3,000 ($5,000 – $2,000 repayment).

The income from a loan repayment can be either capital gain or ordinary income.[21] The income is a capital gain if there is a written obligation to support the loan. Whether the gain is long-term or short-term depends on the length of time the note is held by the shareholder.

Observation. The income is ordinary income if there is no written note. The IRS has not indicated where this is reported. It appears either Schedule E or Form 4797 are reasonable choices.

If there is more than one loan, the restoration of loan basis is applied first entirely to the loan that has been repaid, thereby reducing the gain from the repayment. Any remaining restoration is applied pro rata.[22]

21. IRC §1271(a).

22. Treas. Reg. §1.1367-2.

Example 45. Sharon made two $5,000 loans to her S corporation. Her bases in these two loans are $2,000 for Loan 1 and $3,000 for Loan 2 carried to 2009. Her Schedule K-1 for 2009 shows $500 of ordinary income. The S corporation repaid $1,000 of Loan 1.

Using the default rules results in a restoration of $300 basis to Loan 1 and $200 basis to Loan 2, before calculating the gain from the repayment. The gain on the repayment is $540.

	Loan 1			Loan 2		
	Amount Due	**Basis**	**Reduction**	**Amount Due**	**Basis**	**Reduction**
Beginning balance	$5,000	$2,000	$3,000	$5,000	$3,000	$2,000
Total loan reductions: $3,000 + $2,000 = $5,000						
2009 ordinary income						
	(($3,000 ÷ $5,000) × $500) =	300		(($2,000 ÷ $5,000) × $500) =	200	
New basis		$2,300			$3,200	
Loan repayment	($1,000)			(0)		
Loan balance	$4,000			$5,000		

Gain on repayment = $540 ($1,000 – ($2,300 ÷ $5,000) × $1,000 repayment).

If a shareholder holds more than one loan, any net increase is applied first to restore the reduction in basis in any loans repaid during the year. The basis is restored to the extent necessary to offset any gain that would be recognized on the repayment.[23]

Example 46. Using this special provision, the entire $500 of ordinary income from **Example 45** is used to restore Sharon's basis in Loan 1 to $2,500. The gain on the repayment is $500.

	Loan 1			Loan 2		
	Amount Due	**Basis**	**Reduction**	**Amount Due**	**Basis**	**Reduction**
Beginning balance	$5,000	$2,000	$3,000	$5,000	$3,000	$2,000
2009 ordinary income		500			0	
New basis		$2,500			$3,000	
Loan repayment	($1,000)			(0)		
Loan balance	$4,000			$5,000		

Gain on repayment = $500 ($1,000 – ($2,500 ÷ $5,000) × $1,000 repayment).

A similar rule applies if the shareholders receive a distribution from the S corporation. The stock basis is restored first up to the amount of the distribution, thereby reducing or eliminating the gain from the distribution. Any remaining restoration is applied to the loans pro rata.

Deducting Unpaid Shareholder Loans

Any unrepaid loan basis remaining when the S corporation terminates is a bad-debt deduction for the shareholder. The form or schedule used to deduct this amount depends on the reasons for the loan.

23. Treas. Reg. §1.1367(c)(2).

Most bad debts of shareholder S corporation loans are nonbusiness bad debts, which are deducted on Schedule D as short-term losses. It is assumed the shareholders are making the loans to protect their investments in the corporation, which is an investment activity, not a business activity.

If the loan was made as part of the shareholder's business of lending money, then the loss is deductible on the shareholder's Schedule C as a business bad debt.

If the loan was made as part of the shareholder's business of being an employee and there is a valid business reason for the loan, the bad debt is an employee business expense, deductible on Form 2106, *Employee Business Expenses*, and is carried to Schedule A as a miscellaneous itemized deduction subject to the 2% AGI limitation. This allows the entire deduction in the year the debt is determined to be bad. It could create an NOL if it is large enough, although it also could trigger AMT since 2% miscellaneous itemized deductions are AMT addbacks.

In the case of *Litwin*, from the early 1990s, the taxpayer was allowed to treat the bad debt as an employee business expense. Mr. Litwin started his own corporation, hired himself, made lots of money and sold the corporation at a profit. He did this a second time and was again successful. The third time he did this, the corporation lost money and he had to defer paying himself the large salaries he was accustomed to receiving. He sold the corporation, but continued working for the new owners, again at a deferred pay. He loaned the corporation over $300,000 to keep it operating. When the corporation failed, Mr. Litwin claimed a business loss for the $300,000. Mr. Litwin took the position that he loaned the money to the corporation because:

- The corporation must continue to operate in order to pay him the deferred salary,
- He could not get other jobs due to his advanced age (he was in his 50s), and
- The $300,000 was reasonable compared to his salary (which was nearly $100,000).

The court allowed the deduction, partly based on Mr. Litwin's position and partly based on his past successes. The court stated the fact that Mr. Litwin deferred salary did not harm his case because the corporation's minutes showed he was due the deferred salary and expected to be paid at some time in the future.[24]

Observation. When taking a position similar to the *Litwin* case, keep in mind the "prudent business person" factor. How would a prudent business person act? For example, would he lend $300,000 to his employer so the employer could stay afloat and continue paying his $100,000 per year salary?

Note. Treas. Reg. §1.1367-2 contains rules effective for advances made after October 20, 2008. These rules can cause gain to be recognized much more quickly than under prior rules. The discussion of this regulation is found in Chapter 8, Related Parties.

24. *Litwin v. U.S.*, 983 F.2d 997, 71 AFTR 2d 93-647 (Jan. 12, 1993).