Chapter 3: Calculating Basis

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Please note. Corrections were made to this workbook through January of 2020. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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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 taxpayer's income taxes. Basis as defined in IRS Pub. 551, *Basis of Assets,* is the amount of the taxpayer's investment in property for tax purposes. This amount is needed to calculate depreciation, amortization, depletion, casualty losses, gain or loss on the sale or other disposition of property, and the qualified business income deduction for certain taxpayers. For certain kinds of property, such as inherited property, special rules must be applied to determine basis. The taxpayer must keep records that show the cost basis and the adjusted basis, if applicable, of property.

The computation of basis has differing results under various scenarios. Many different types of assets or events are discussed in this chapter to illustrate the variations of basis applicable to individual taxpayers.

COST BASIS

A taxpayer's basis in property is usually its cost, which includes the amount paid in cash, debt obligations, and other property or services. The cost of property may also include amounts paid for the following.[1]

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

ADJUSTED BASIS[2]

The taxpayer's basis in property must be adjusted before calculating their gain or loss on a sale or other disposition of property or calculating the taxpayer's allowable depreciation. Following is a list of some of the adjustments to basis that must be taken into account to arrive at the taxpayer's adjusted basis.

Increases to Basis

- Improvements having a useful life of more than one year
- Rehabilitation expenses less any rehabilitation credit allowed
- Cost of extending utility service lines to business property
- Legal fees (e.g., fees for defending and perfecting title)
- Assessments for local improvements (e.g., assessments for paving roads and building ditches that increase the property's value)

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1. IRS Pub. 551, *Basis of Assets*.
2. Ibid.

Decreases to Basis

- Deductions allowed (or allowable) for amortization, depreciation, and depletion
- IRC §179 deduction
- Residential energy credits
- Investment credit taken
- Casualty and theft losses and insurance reimbursement
- Easements
- Election to reduce basis due to debt forgiveness not included in income under IRC §108

Note. For more information on items that can increase or decrease basis, see IRS Pub. 551. For information pertaining to basis calculations for S corporation shareholders and partners in a partnership, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Schedule K-1.

RECORDKEEPING

Taxpayers must maintain accurate records that show the basis of property and, if applicable, the adjusted basis.[3] The taxpayer must keep property records for assets until the limitations period expires for the year in which they dispose of the property in a taxable disposition. If the taxpayer received property in a nontaxable exchange, they must keep records on the old and new properties until the limitations period expires (generally three years) for the year in which they dispose of the new property in a taxable disposition.[4]

Note. For more information about the limitations period, see the 2019 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Ethics in Tax Practice.

If a taxpayer fails to maintain adequate records, the IRS can assume that the basis of the property is zero.[5] However, under IRC §7491, a taxpayer may be able to establish cost basis by producing credible evidence, which can include the following.

- Title insurance taken on the property at the time of purchase[6]
- Records that show amount withdrawn from taxpayer's bank account shortly before the purchase of the property for the purported cost of the property[7]
- Credible testimony of the taxpayer[8]

Taxpayers without adequate records may be able to invoke the *Cohan* rule.[9] Under this rule, the taxpayer presents the court with an estimate of costs. The court then determines whether to accept the estimate, which can depend on such factors as the reason the records are not available and the efforts the taxpayer demonstrated in attempting to keep or reconstruct records. The court can accept, modify, or reject the taxpayer's estimate.[10]

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3. Instructions for Schedule D; IRS Pub. 551, *Basis of Assets.*
4. IRS Pub. 583, *Starting a Business and Keeping Records.*
5. See, e.g., *Spurgeon v. Comm'r,* TC Memo 1977-326 (Sep. 21, 1977).
6. *Hirst v. Comm'r,* TC Memo 1986-321 (Jul. 28, 1986).
7. *McBride v. Comm'r,* TC Memo 1987-94 (Feb. 17, 1987).
8. *Young v. Comm'r,* TC Memo 1985-221 (May 9, 1985).
9. See *George M. Cohan v. Comm'r,* 39 F.2d 540 (2nd Cir. 1930).
10. *Estimates and the Cohan Rule.* Brophy, Joseph D. Oct. 1, 2009. The Tax Adviser. [www.thetaxadviser.com/issues/2009/oct/estimatesandthecohanrule.html] Accessed on Mar. 12, 2019.

If a tax professional assists their client in estimating basis and it is challenged, they may be subject to penalties, including the following.

- IRC §6694 penalty for understating the taxpayer's liability
- IRC §6662(d) penalty for taking a position for which there is no substantial authority

Therefore, it may be prudent for the tax professional to prepare Form 8275, *Disclosure Statement,* to disclose such estimates. By filing this form, the tax professional can avoid the portions of the accuracy-related penalty due to disregard of rules or substantial understatement of income tax if the return position has a reasonable basis.[11]

STOCKS AND BONDS

The basis of stocks and bonds is usually the taxpayer's purchase price plus costs of purchase, including commissions and recording or transfer fees. If the taxpayer acquired stocks or bonds by a method other than by purchasing, their basis is usually determined by reference to fair market value (FMV) or the previous owner's adjusted basis.[12]

Practitioner Planning Tip

If a client does not have documentation for the cost basis of a security, it can be estimated by starting with the FMV on the date the security was purchased. This may need to be further adjusted for any stock splits or dividends. A broker may be able to provide any missing information.

Stock basis must be adjusted for certain events that occur after purchase. For example, if the taxpayer receives additional shares from nontaxable stock dividends or stock splits, the basis of their original stock must be reduced. Stock basis must also be reduced when the taxpayer receives nondividend distributions.[13]

Facts for Scenarios 1A–1C. Carlos has his tax return prepared by Prudence every year. When they meet in March 2019, Prudence learns that Carlos acquired some additional stock in 2018. He is single. His taxable income for the year is $125,000, putting him in the 15% long-term capital gains tax bracket.

NONTAXABLE STOCK DIVIDENDS[14]

Stock dividends are distributions a corporation makes of its own stock. Stock dividends are usually not taxable. If the stock dividend is not taxable, the taxpayer must divide their basis for the old stock between the old stock and the new stock.

Note. See IRS Pub. 550, *Investment Income and Expenses,* for an explanation of situations in which stock dividend distributions **are** taxable.

11. Instructions for Form 8275.

12. IRS Pub. 550, *Investment Income and Expenses.*

13. Ibid.

14. Ibid.

New Stock Identical to Old Stock

If the stock the taxpayer receives as a nontaxable dividend is identical to the old stock on which the dividend was declared, the taxpayer should divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is the shareholder's basis for each share of stock.

Scenario 1A. Carlos owned one share of common stock of Bapple, Inc., that he bought for $1,000 in 2016. In 2018, Bapple distributed two new shares of common stock for each share held. Carlos tells Prudence that he is considering selling his new stock and wants to know what the tax on the sale would be. The current FMV of the Bapple stock is $500 per share.

Scenario 1A Discussion. Carlos received two new shares of Bapple common stock that were identical to the one share that he already owned. Accordingly, to compute the basis for each share of Bapple stock that Carlos owns, Prudence divides the adjusted basis of the old stock by the number of shares of old and new stock. Therefore, Carlos' basis for each share is $333.33 ($1,000 cost of old stock ÷ 3 shares).

Prudence informs Carlos that if he sells his three shares of Bapple stock for the current FMV of $500 each, his tax on capital gains will be $75.

Selling price ($500 × 3 shares)	$1,500
Less: basis ($333.33 × 3 shares)	(1,000)
Gain on sale	$ 500
Capital gains tax rate	× 15%
Tax on capital gains	$ 75

New Stock Not Identical to Old Stock

If the taxpayer receives a nontaxable dividend that consists of new stock that is **not** identical to the old stock on which the dividend was declared, the basis is calculated by dividing the adjusted basis of the old stock between the old and the new stock in the ratio of the FMV of each lot of stock to the total FMV of both lots on the distribution date of the new stock.

Scenario 1B. Carlos also owned one share of Wanna common stock that he bought in 2016 for $400. In 2018, Wanna distributed a share of preferred stock for each share of common stock held. On the distribution date, the common stock had an FMV of $450 and the preferred stock had an FMV of $50. The current FMV of the Wanna common stock is $475 and the FMV of the preferred stock is $42. Carlos asks Prudence what the taxes would be on the sale of the common stock.

Scenario 1B Discussion. Carlos owned one share of Wanna stock that he bought in 2016 for $400. Carlos' basis in the Wanna stock is calculated by dividing the adjusted basis of the old stock between the old and the new stock in the ratio of the FMV of each lot of stock to the total FMV of both lots on the distribution date of the new stock. On the distribution date, the common stock had an FMV of $450 and the preferred stock had an FMV of $50. Carlos' basis in the common and preferred shares is calculated by dividing the $400 basis between them. Carlos' common stock basis is $360 ($450 FMV common stock ÷ $500 total FMV of common and preferred stock × $400 adjusted basis of old stock). His preferred stock basis is $40 ($50 FMV preferred stock ÷ $500 total FMV of common and preferred stock × $400 adjusted basis of old stock).

Prudence tells Carlos that if he sells his share of Wanna **common stock** for its current FMV of $475, his tax on capital gains will be $17.

Selling price	$475
Less: basis	(360)
Gain on sale	$115
Capital gains tax rate	× 15%
Tax on capital gains	$ 17

STOCK SPLITS[15]

The basis of stock splits is calculated in the same manner as the basis of stock that the taxpayer receives as a nontaxable dividend that is identical to the old stock on which the dividend was declared (explained previously).

NONDIVIDEND DISTRIBUTIONS[16]

Nondividend distributions are distributions that are not paid out of a corporation's (or mutual fund's) earnings and profits. Such distributions are reported in box 3 of Form 1099-DIV, *Dividends and Distributions.*

Nondividend distributions are a nontaxable return of capital, up to the amount of the taxpayer's basis. These distributions are not taxed until the taxpayer fully recovers their basis in the stock. When the taxpayer's stock basis has been reduced to zero, any additional nondividend distributions are reported as a capital gain. If the taxpayer bought stock in the corporation at different times and cannot definitely identify the shares subject to the nondividend distribution, they should reduce the basis of their earliest purchases first. If the taxpayer held the stock more than one year, the distribution is a long-term capital gain. If the taxpayer held the stock for one year or less, the distribution is a short-term capital gain.

Scenario 1C. Carlos also bought one share of ND stock in 2015 for $500 per share. He received a nondividend distribution of $300 in 2018. In February 2019, he received another nondividend distribution of $250.

Carlos asks Prudence about the tax effect of the nondividend distributions on the ND stock.

Scenario 1C Discussion. The $300 nondividend distribution that Carlos received on his ND stock in 2018 reduced his basis to $200 ($500 basis – $300 distribution). This transaction is not taxable because Carlos still has basis in the stock.

In February 2019, Carlos received another nondividend distribution of $250 on the ND stock. The first $200 of this $250 nondividend distribution reduced his basis to zero. He must report the additional $50 per share ($250 distribution – $200 return of basis) as a long-term capital gain for 2019. If Carlos receives any further nondividend distributions on his ND stock in subsequent years, he will report these as long-term capital gains.

IDENTIFICATION OF STOCKS OR BONDS SOLD[17]

When the taxpayer can adequately identify the shares of stock or bonds they sold, their basis is the cost or other basis of the particular shares sold. The taxpayer makes an adequate identification if they show the certificates representing shares of stock from a lot that they bought on a certain date or for a certain price were delivered to their broker or other agent.

Stock or Bond Held by Broker

If stock or bond certificates are held by a broker or other agent, the taxpayer makes an adequate identification if they tell the broker (or other agent) the particular security to be sold or transferred at the time of the sale or transfer. The broker must issue a written confirmation of this transaction within a reasonable time. The security identified in this way is the security sold or transferred even if the broker delivers stock or bond certificates from a different lot.

Identification Not Possible

If the taxpayer buys and sells securities at different times and in different quantities and they cannot adequately identify the shares sold, the basis of the securities sold is determined using the first-in, first-out (FIFO) method.

15. Ibid.

16. Ibid.

17. Ibid.

MUTUAL FUND SHARES[18]

The basis of shares in a mutual fund or a real estate investment trust (REIT) is generally calculated in the same way as the basis of other stock. The basis usually includes any commissions or sales (load) charges paid.

Scenario 2A Facts. Logan owned 1,400 identical shares of Energy Markets Equity and Income Fund (EMX). The following table shows his acquisition and basis history.

Date	Type of Acquisition	No. of Shares	Price Per Share	Basis
September 9, 2017	Purchase	1,000	$20	$20,000
December 1, 2017	Purchase	50	15	750
December 1, 2017	Purchase	150	15	2,250
December 1, 2018	Purchase	30	35	1,050
December 1, 2018	Purchase	170	35	5,950
Totals		1,400		$30,000

On September 18, 2019, Logan sold 700 shares of EMX for $40 per share, for total gross proceeds of $28,000. He asked his tax preparer, Winston, what the tax consequences of the sale are. His ordinary marginal tax rate is 22% and his capital gains tax rate is 15%.

When mutual fund shares are sold, exchanged, or otherwise disposed of, gain or loss is measured by the difference between the amount realized from the sale of the fund shares and the basis of those shares. If all the shares in a fund are disposed of in a single transaction, the basis determination is not complex. However, the basis calculation is more difficult when only a portion of a taxpayer's interest in a fund is disposed of and the shares were acquired at different times and at different prices. In this situation, a taxpayer can choose any of the following three methods to determine the basis of their mutual fund shares when the taxpayer sells the shares.

1. **Specific share identification method** allows a taxpayer to plan the amount of gain/loss that they will realize upon the sale of some (but not all) of their shares in a particular investment. If the taxpayer adequately identifies the shares they sold, they use the adjusted basis of those specific shares to calculate their gain or loss. The taxpayer adequately identifies their mutual fund shares by indicating to the broker **at the time of the sale** exactly which shares or lots that they are selling. The taxpayer also must receive confirmation of their specification in writing from the broker.

Note. See the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation, for a discussion of the methods of calculating basis to determine which specific stocks to sell. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

2. The **FIFO method** is used when the taxpayer does not (or cannot) specifically identify the shares sold. Under this method, the shares acquired first are the shares treated as sold first.

3. The **average basis method** averages the basis of all of the shares of an identical stock in an account regardless of the holding period. This method is explained in detail next.

The basis of mutual fund shares that were acquired by reinvesting distributions from the fund is calculated using the amount of the distributions that were used to purchase each full or fractional share. This rule applies even if the distribution is an exempt-interest dividend that was not taxed.

18. Ibid.

Practitioner Planning Tip

The basis of mutual fund shares can only be calculated using the specific share identification method or the FIFO method if the taxpayer did not previously use an average basis method for a sale, exchange, or redemption of other shares in the same mutual fund.

Average Basis Method

A taxpayer can use the average basis method to determine the basis of the shares if the shares are identical, the taxpayer acquired them at different times and prices, and left them in an account maintained by a custodian or agent. In addition, the average basis method can only be used for the following types of investments.

- Shares in mutual funds and other regulated investment companies (RICs)
- Shares held in connection with a dividend reinvestment plan (DRP) if all shares in the account are covered securities
- Shares acquired after 2011 in connection with a DRP

Although the basis is determined using the average cost of the investment, the character of the gain/loss as short- or long-term is determined using the FIFO method.

Scenario 2A Discussion. After studying Logan's records relevant to the mutual fund transactions, Winston learned that EMX sent Logan a cost-basis election form when he first purchased shares in the mutual fund. Logan chose the average basis method based on advice from his brother. Winston decided to calculate the tax consequences of Logan's sale using the specific share identification method, the FIFO method, and the average basis method. He hopes that this will encourage Logan to consult him before making any final decisions relevant to stock transactions in the future.

Practitioner Planning Tip

If the taxpayer places shares of stock in the custody of a broker, the basis of the shares is determined in accordance with the broker's default method unless the taxpayer notifies the broker that the taxpayer elects another permitted method. The taxpayer must report gain or loss using the method the taxpayer elects or, if the taxpayer does not make an election, the broker's default method.[19] Practitioners may want to counsel their clients to consult with them before making any decisions regarding securities or other property.

19. Treas. Reg. §1.1012-1(e)(2).

1. **Specific Share Identification Method.** Using the specific share identification method, Logan could identify the shares sold as those that had the highest basis. Using this method, he could identify the shares sold as the 200 (170 + 30) shares acquired in 2018 and 500 of the shares purchased on September 9, 2017.

   The 200 shares acquired in 2018 had a combined basis of $7,000 ($1,050 + $5,950). The sales proceeds for these 200 shares was $8,000 (200 shares × $40 sales price per share) and Logan's **short-term** capital gain would be $1,000 ($8,000 – $7,000).

   The 500 shares purchased in September 2017 had a basis of $10,000 (500 shares × $20 price per share). The sales proceeds for these 500 shares was $20,000 (500 shares × $40 sales price per share). Logan's net **long-term** capital gain on these shares would be $10,000 ($20,000 – $10,000).

   By identifying the shares to sell using the highest-cost method, Logan's tax would be **$1,720** ($1,000 short-term gain × 22% ordinary income tax rate) + ($10,000 long-term gain × 15% capital gain rate).

2. **FIFO Method.** If Logan used the FIFO method, his basis would be $14,000 (700 shares × $20 price per share of oldest shares) and his long-term capital gain would be $14,000 ($28,000 total sales price – $14,000 basis). His federal income tax on the sale would be **$2,100** ($14,000 long-term gain × 15% capital gain rate).

3. **Average Basis Method.** Using the average basis method, Logan's average cost per share is $21.43 ($30,000 total basis ÷ 1,400 shares). Therefore, his basis for the 700 shares sold is $15,001 ($21.43 × 700) and his gain is $12,999 ($28,000 total sales price – $15,001 basis). He will report the sale as a long-term capital gain on his 2019 return because the shares disposed of are considered to be those acquired first (i.e., on September 9, 2017). The tax on capital gains on the sale is $1,950 ($12,999 gain × 15%).

   If Logan had informed EMX that he wanted to use the specific share identification method, he could have saved $230 in taxes (**$1,950** taxes using average basis method – $1,720 taxes using specific share identification method) in 2019 on the sale of the EMX shares.

Scenario 2B. Use the same facts as **Scenario 2A,** except Logan bought 50 additional identical shares at $40 per share on October 1, 2019, and then sold 60 shares on December 15, 2019. What is the average basis of the shares he sold on December 15, 2019?

The taxpayer's average basis of shares they still hold after a sale of some of the shares is the same as the average basis of shares sold. The average basis remains the same unless the taxpayer acquires additional shares or makes a subsequent adjustment to basis.

Scenario 2B Discussion. The average basis of the shares Logan sold on December 15, 2019, is $22.67, for a total basis in the shares sold of $1,360. This is calculated as follows.

	No. of Shares	Total Basis
Basis before sale	1,400	$30,000
Less: basis of shares sold	(700)	(15,001)
Remaining shares	700	$14,999
Shares acquired October 1, 2019 (cost: $40 per share)	50	2,000
Totals	750	$16,999
Divided by no. of shares		÷ 750
Average basis per share		$22.67
Shares sold in December 2019		× 60
Basis of shares sold		$ 1,360

Observation. Information provided by the mutual fund may include the average basis of the shares.

Election to Use Average Basis Method for Covered Securities. To make the election to use the average basis method for covered securities, the taxpayer must send written notice to the custodian or agent who keeps the account. The taxpayer can send the written notice electronically. The taxpayer must also notify their broker of the election. Generally, a **covered security** is a security acquired after 2010.

> **Note.** For more information about covered securities, see IRC §6045(g) and Treas. Reg. §1.6045-1.

A taxpayer may make the election to use the average basis method at any time. The election is effective for sales or other dispositions of stocks that occur after the taxpayer notifies the custodian or agent of the election. The election must identify each account with that custodian or agent and each stock in that account to which the election applies. However, the election can also indicate that it applies to all accounts with a custodian or agent, including accounts later established with the custodian or agent.

The taxpayer can revoke the election to use the average basis method for covered securities by sending written notice to the custodian or agent holding the stock. The taxpayer must generally revoke the election by the earlier of the following dates.[20]

- One year after the election is made
- The date of the first sale, transfer, or disposition of the stock following the election

The revocation applies to all the stock in an account that is identical to the shares of stock for which the taxpayer is revoking the election. After revocation, the taxpayer's basis in the shares of stock to which the revocation applies is the basis before averaging.[21]

A taxpayer has not made an election to use the average basis method if the taxpayer fails to notify a broker of the taxpayer's basis determination method and basis is determined by applying the broker's default method.[22] In this situation, a taxpayer can change from the average basis method to another basis determination method, and the basis of each share of stock immediately after the change is the same as the basis immediately before the change.[23] The change in basis determination methods applies prospectively. The taxpayer must notify, in writing by any reasonable means, the custodian or agent holding the stock to which the change applies.[24] Because the taxpayer did not make an election, this is not considered a revocation.[25]

Election to Use Average Basis Method for Noncovered Securities. For noncovered securities, a taxpayer elects to use the average basis method on their income tax return for the first tax year that the election applies. The taxpayer makes the election by indicating on the return that they used the average basis method for reporting gain or loss on the sale or other disposition.[26] The taxpayer can also make the election on an amended return filed no later than the due date (including extensions) for filing the original return for the tax year for which the election applies.[27]

Following is a sample statement that can be used for making the election.

> **Mutual Fund Basis Election**
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> Under Treasury Regulation 1.1012-1(e), the taxpayer elects to determine the basis of all mutual fund shares sold in this and subsequent tax years using the average basis, single category method.

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20. Treas. Reg. §1.1012-1(e)(9)(iii).
21. Ibid.
22. Treas. Reg. §1.1012-1(e)(9)(i).
23. Treas. Reg. §1.1012-1(e)(7)(v).
24. Treas. Reg. §1.1012-1(e)(9)(iv).
25. Treas. Reg. §1.1012-1(e)(9)(v), Example 2.
26. IRS Pub. 550, *Investment Income and Expenses.*
27. Treas. Reg. §1.1012-1(e)(9)(ii).

BOND PREMIUMS[28]

If a taxpayer purchases a bond at a premium, the premium is treated as part of the taxpayer's basis in the bond. If a taxpayer elects to amortize the premium paid on a taxable bond, they must reduce the bond's basis by the amortized portion of the premium each year over the bond's life. The taxpayer elects to amortize the premium by reporting the amortization for the year on their tax return for the first tax year for which the election applies. The taxpayer should attach a statement to their return that they are making the election under IRC §171. The choice to amortize is binding for the year of the election and all subsequent years. A taxpayer who makes the election must amortize all taxable bonds they owned in the year of the election and also taxable bonds acquired in subsequent years.

The premium on a tax-exempt bond cannot be deducted. However, a taxpayer must amortize it to determine their adjusted basis in the bond. The bond's basis must be reduced by the premium amortized during the period the taxpayer held the bond.

> **Note.** For information about the calculation of bond premium amortization and how to report amortization, see IRS Pub. 550.

MARKET DISCOUNT ON BONDS[29]

Market discount is the amount of the stated redemption price of a bond at maturity that exceeds the taxpayer's basis in the bond immediately after they acquire it. Market discount on a bond occurs when the value of a debt obligation decreases after its issue date. This is usually because of an increase in interest rates.

A taxpayer can choose to accrue the market discount over the period they own the bond and include it in their income currently as interest income. If a taxpayer includes market discount on a bond in income in the current year, they should increase the bond's basis by the amount of market discount included in their income.

> **Note.** For information about the calculation of accrued market discount and making the choice to include market discount in income currently, see IRS Pub. 550.

STOCK OPTIONS

Employees may receive an option to buy or sell stock as payment for their services.[30] Stock options are generally rights to purchase a stock at a specified price within a certain period of time.[31] There are two kinds of stock options.[32]

1. **Statutory stock options** are options granted under an incentive stock option (ISO) plan or an employee stock purchase plan (ESPP).
2. **Nonstatutory stock options** are stock options that are not granted under an ISO plan or an ESPP.

Each type is treated differently for tax purposes.[33]

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28. IRS Pub. 550, *Investment Income and Expenses.*
29. Ibid.
30. IRS Pub. 525, *Taxable and Nontaxable Income.*
31. *Stock Option.* Investopedia. [www.investopedia.com/terms/s/stockoption.asp] Accessed on Nov. 1, 2018.
32. *Topic Number 427—Stock Options.* Feb. 22, 2019. IRS. [www.irs.gov/taxtopics/tc427] Accessed on Mar. 11, 2019.
33. IRS Pub. 525, *Taxable and Nontaxable Income.*

Statutory Stock Options[34]

Scenario 3 Facts. Kaylynn was granted an incentive stock option to purchase 200 shares at $4 per share from her employer on December 24, 2017. She exercised the option (purchased the stock) on July 5, 2018, when the FMV was $10. She sells 100 of the shares on July 31, 2019, when the FMV was $23. She sells the remaining 100 shares on December 31, 2019, when the FMV was still $23. What is Kaylynn's basis in the shares? What is the nature and amount of income that Kaylynn recognizes from these transactions?

For either type of statutory stock option (ISO or ESPP), the following requirements must be met.

- The taxpayer must be employed by the company (or a related company) granting the option at the time the option is granted.
- The taxpayer must remain an employee of the company continuously beginning on the date the option is granted and ending three months before the option is actually exercised.
- The option granted must be nontransferable, except upon the taxpayer's death.

If these requirements are not met, the option is treated as nonstatutory.

For both types of statutory options, the taxpayer does not include any amount in income when the option is granted or when they exercise the option.[35]

Incentive Stock Options. An ISO is an option to purchase stock at a reduced rate. If a taxpayer sells stock acquired by exercising an ISO, they need to determine if they satisfied the **holding period requirement.** The taxpayer satisfies this requirement if they do not sell the stock until the later of:

- Two years from the granting of the option, or
- One year after the stock is transferred to the taxpayer.

The holding period begins on the day after the taxpayer exercises the option.

Holding Period Requirement Met. If the taxpayer meets the holding period requirement, all gain or loss at disposition is a capital gain or loss. The **basis** of the stock is the amount the taxpayer paid for the stock.

Scenario 3 Discussion. Kaylynn **meets the holding period requirement** for the 100 shares that she purchased on July 5, 2018, and sold on December 31, 2019, 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. Therefore, she receives capital gain treatment on the sale. Her basis in the stock is $4 per share, which is the amount she paid for the shares. Kaylynn recognizes a capital gain of $1,900 (($23 FMV – $4 basis) × 100 shares).

Holding Period Requirement Not Met. If an employee (or former employee) sells stock at a gain that they acquired through exercising an ISO but does **not** satisfy the holding period requirement, the gain is ordinary income up to the amount by which the stock's FMV at exercise exceeds the option price. Any excess gain is capital gain. The employer reports the ordinary income as wages in box 1 of Form W-2, *Wage and Tax Statement*. However, if the employer (or former employer) does not include the ordinary income in box 1 of Form W-2, then the taxpayer must still report the ordinary income as wages on Form 1040, *U.S. Individual Income Tax Return,* for the year of the sale or other disposition. The taxpayer's **basis** is the amount they paid when they exercised the option plus the amount reported as wages.

If the taxpayer has a loss from the sale of an ISO and does not meet the holding period requirement, it is a capital loss.

34. Ibid.

35. Also see IRC §421(a)(1).

Scenario 3 Discussion. Kaylynn **did not meet the holding period requirement** for the shares she sold on July 31, 2019, because the shares were sold less than two years after the option was granted. Consequently, she recognizes ordinary wage income of $600 (($10 FMV on the exercise date – $4 option price) × 100 shares). Her basis is $1,000 (($4 purchase price × 100 shares) + $600 wage income). She also recognizes a capital gain of $1,300 (($23 sales price × 100 shares) – $1,000 basis).

Alternative Minimum Tax Basis. If the taxpayer is subject to alternative minimum tax (AMT), their ISO shares will have two bases: a basis for regular tax purposes (explained earlier) and a basis for AMT purposes (option price plus AMT adjustment).

Scenario 4 Facts. Colin's employer, Rex Corporation, granted him an ISO on May 5, 2017, to buy 100 shares of Rex Corporation stock at $15 per share, which was its FMV at that time. Colin exercised the option on January 8, 2018, when the stock's FMV was $18 per share. On January 31, 2018, Colin's rights to the stock first became transferable. The stock's FMV on that date was $20 per share. Colin sells the stock on December 31, 2019, for $25 per share. How does Colin report the transaction for AMT purposes? What is his basis?

For AMT purposes, a taxpayer who purchases stock through the exercise of an ISO must treat the stock as if no special rules apply. This means that when the taxpayer's rights in the stock are transferable or no longer subject to a substantial risk of forfeiture, they must include as an adjustment in calculating alternative minimum taxable income the amount by which the stock's FMV exceeds the option price. This adjustment is reported on Form 6251, *Alternative Minimum Tax—Individuals.* The taxpayer's AMT basis is also increased by the amount of this adjustment. However, no adjustment is necessary if the taxpayer disposes of the stock in the same year they exercise the option.[36]

Scenario 4 Discussion. Colin's rights to the stock became transferable on January 31, 2018. He did not dispose of the stock by the end of 2018, so he reported $500 (($20 FMV when rights first became transferable – $15 option price) × 100 shares) as a positive adjustment on his 2018 Form 6251.

Colin sells the stock on December 31, 2019, for $25 per share. He meets the holding period requirement, so he receives capital gain treatment on the sale. Colin's basis for regular tax purposes is $1,500 ($15 option price × 100 shares). His AMT basis is $2,000 ($1,500 regular tax basis + $500 AMT adjustment), resulting in a $500 negative adjustment on his 2019 Form 6251.

Employee Stock Purchase Plan. If a taxpayer sells stock that they acquired by exercising an option granted under an ESPP, they need to determine if they satisfied the holding period requirement. The holding period is the same as described earlier for an ISO.

The option price cannot be less than the lesser of:[37]

- 85% of the stock's FMV at the time the option is granted, or
- Not less than 85% of the stock's FMV at the time the option is exercised.

Holding Period Requirement Satisfied. If a taxpayer meets the holding period requirement, their basis is the option price at the time they exercised the option and acquired the stock.

Scenario 5 Facts. Mayfare Co. has an ESPP. The option price is the lower of the stock price when the option is granted or at the time the option is exercised. The stock's value when Mayfare granted the option to Leesa on January 1, **2017,** was $25. Leesa exercised her option on February 1, **2018.** Mayfare deducted $10 from her weekly pay for 48 weeks, starting on February 2, **2018,** for a total of $480. The stock's value when the option was exercised was $20. Leesa received 24 shares of Mayfare stock ($480 ÷ $20). She sold the stock on April 1, **2019.**

When did Leesa's holding period for her shares begin? What is her basis?

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36. Also see IRC §56(b)(3).

37. Treas. Reg. §1.423-2(a)(3)(iv).

The timing and amount of pay period deductions do not affect the basis. The holding period begins the day after a taxpayer exercises the option.

Scenario 5 Discussion. Leesa's holding period for all 24 shares began the day after she exercised the option (February 2, 2018), even though the money used to purchase the stock shares was deducted from her pay over 48 weeks. She meets the holding period requirement. Therefore, her basis in each share is $20, the option price at the time she exercised the option and acquired the stock.

Option Granted at Discount. An option is granted at a discount if the option price was less than 100% (but not less than 85%) of the share's FMV at the time the option was granted.

Scenario 6A Facts. Main Corporation granted Robin the right to buy company stock at a 15% discount on June 1, 2017. On the grant date, the option price was $85 and the FMV was $100. On June 2, 2018, Robin exercised the option when the stock value was $110.

On June 15, 2019, Robin sold the stock for $150 per share. What amount is included in Robin's compensation income? What is Robin's stock basis?

If the taxpayer meets the holding period requirement (or dies while owning the share), the taxpayer must include the **lesser** of the following amounts in their compensation income.

- Excess of the share's FMV at the time the option was granted over the option price
- Excess of the share's FMV at the time of the disposition or death over the amount paid for the share

Any excess gain is capital gain. If the taxpayer incurs a loss from the sale, it is a capital loss.

Any amount included in the taxpayer's compensation income is added to the basis of the stock option.[38]

Scenario 6A Discussion. Robin meets the holding period requirement. Her 2019 Form W-2 includes the $15 discount ($100 FMV on grant date – $85 option price) in compensation income. Robin's stock basis is $100 ($85 option price + $15 compensation income). Her $50 gain ($150 sales price – $100 basis) on the sale is a capital gain.

Holding Period Requirement Not Satisfied. If the taxpayer does **not** satisfy the holding period requirement, they must include in compensation income the amount by which the stock's FMV when they exercised the option exceeded the option price. The taxpayer's basis is increased by the amount of the compensation income. The difference between the taxpayer's increased basis and the stock's selling price is a capital gain or loss.

Scenario 6B Facts. Robin sold the stock for $150 per share 10 months after exercising the option. How does this affect Robin's compensation income and stock basis?

Scenario 6B Discussion. Robin sold the stock 10 months after exercising the option, so she does not satisfy the holding period requirement. This means Robin must include $25 ($110 FMV at exercise date – $85 option price) in compensation income. Her basis increases to $110 ($85 + $25). Robin's capital gain is $40 ($150 sales price – $110 basis).

38. Treas. Reg. §1.423-2(k)(2).

Nonstatutory Stock Options

Scenario 7 Facts. Avett Corporation issued nonstatutory stock options to Seth in 2018. Seth can purchase company stock at a 15% discount. He exercised the option and paid $85 when the FMV of the stock was $100 per share. What is Seth's basis in the share?

Nonstatutory stock options, sometimes referred to as "nonqualified stock options" (NQSOs), are addressed by IRC §83(a). With a nonstatutory stock option, additional compensation income is recognized at the time the option is granted only when the requirements of §83(a) are met and only if the option has a readily ascertainable value at the time the option is granted.[39]

If the value of the option is not readily ascertainable at the time of the grant, the taxpayer recognizes income at the time the option is **exercised** or **disposed of.**[40] Although it is possible for a nonmarket-traded option to have a readily ascertainable value,[41] as a practical matter, most small business options do not have a value that can be ascertained at the time of grant. These options therefore do not trigger income until **exercised or transferred.**[42]

Note. The taxpayer receiving a nonstatutory stock option without a readily ascertainable value has no taxable event until the option is exercised. However, a special tax election is available under IRC §83(b) to report the additional compensation income in the year the option is granted. This election is available for stock options and any other property received that is covered by §83(a). The election is generally irrevocable.[43]

If a taxpayer has income from the exercise of nonstatutory stock options, the employer should report it by designating code V in box 12 of Form W-2. The employer should report the "spread" (i.e., the FMV of stock minus the exercise price of the option granted to the employee for the stock). The employer also reports this amount in boxes 1 (wages, tips, and other compensation), 3 (social security wages), and 5 (Medicare wages and tips).[44]

The **basis** of the nonstatutory stock option is the amount the taxpayer paid for it plus any amount included in income upon grant or exercise of the option.[45]

Scenario 7 Discussion. Avett Corporation reports the $15 discount ($100 FMV – $85 exercise price) on Seth's 2018 Form W-2 in box 12, using code V. Avett also includes this amount in Seth's income reported in boxes 1, 3, and 5. Seth's basis in the share is $100 ($85 paid for share + $15 included in income).

WASH SALES[46]

A wash sale occurs when a taxpayer sells or trades stock or securities at a loss and within 30 days before or after the sale, they do one of the following.

1. Buy substantially identical stock or securities
2. Acquire substantially identical stock or securities in a fully taxable trade
3. Acquire a contract or option to buy substantially identical stock or securities
4. Acquire substantially identical stock for their traditional or Roth individual retirement arrangement (IRA)

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39. Treas. Reg. §1.83-7(a).
40. Ibid; IRS Pub. 525, *Taxable and Nontaxable Income.*
41. Treas. Reg. §1.83-7(b).
42. IRS Pub. 525, *Taxable and Nontaxable Income.*
43. See Treas. Reg. §1.83-2.
44. IRS Pub. 525, *Taxable and Nontaxable Income.*
45. Ibid.
46. IRS Pub. 550, *Investment Income and Expenses.*

A taxpayer generally cannot deduct losses from sales or trades of stock or securities in a wash sale. However, the wash sale rules do not apply to a **dealer** in stock or securities if the loss incurred by the dealer is from a transaction made in the ordinary course of business.

If a taxpayer incurs a loss that was disallowed under the wash sale rules, the disallowed loss is added to the cost of the new stock or securities (except in item 4 above). The increased amount is the taxpayer's basis in the new stock or securities.

Scenario 8A Facts. Sally purchased 300 shares of **Peppy stock** for $3,000 on February 16, 2018. She sold the Peppy stock for $2,100 on July 3, 2018. She repurchased 300 shares of Peppy stock on July 10, 2018, for $1,500. What is Sally's basis in the Peppy stock? How much of a loss can she claim on the sale?

Scenario 8A Discussion. Sally's repurchase of 300 shares of **Peppy stock** on July 10, 2018, is within 30 days before or after the sale date of 300 shares of Peppy stock (July 3, 2018). Therefore, Sally cannot claim the $900 loss ($2,100 sale price – $3,000 purchase price). Sally's basis in the new shares is $2,400 ($1,500 cost + $900 disallowed wash sale loss).

If the number of shares of substantially identical stock the taxpayer buys within 30 days before or after the sale is more or less than the number of shares sold, the taxpayer must match the shares bought with an equal number of shares sold.

Scenario 8B Facts. Sally also purchased 300 shares of **Sprightly stock** for $3,000 on March 1, 2018. She sold the Sprightly stock for $2,100 on July 3, 2018, resulting in a $900 loss. She repurchased 100 shares of Sprightly stock on July 10, 2018, for $800 and did not buy any other shares of Sprightly stock. What is Sally's basis in the Sprightly stock and how much of a loss can she claim on the sale?

Scenario 8B Discussion. Because Sally's repurchase of **Sprightly stock** on July 10, 2018, is within 30 days before or after the sale date (July 3, 2018), she cannot recognize the $300 loss related to the 100 shares of **Sprightly stock** she repurchased ($900 loss × (100 shares repurchased ÷ 300 total shares)). However, she 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 new stock or securities includes the holding period of the stock or securities sold.

Scenario 8C Facts. Sally purchased 500 shares of **Specific Motors, Inc.** (SMI) stock on February 17, 2018, for $2,000. She sold the shares for $1,000 on March 9, 2018. Sally repurchased 500 shares of SMI stock on April 1, 2018, for $900. What is Sally's basis in the SMI stock and how much of a loss can she claim on the sale? What is her holding period for the stock?

Scenario 8C Discussion. Sally's $1,000 loss ($2,000 purchase price – $1,000 sales price) on the **SMI stock** is also disallowed due to the wash sale rules. Her basis in the repurchased SMI stock is $1,900 ($900 cost of repurchased shares + $1,000 disallowed wash sale loss). Her holding period for the repurchased SMI stock is the time she holds the repurchased stock plus the 20 days (February 17, 2018 – March 9, 2018) she held the SMI stock sold at a loss.

A sale that is subject to the wash sale rules must be reported on Form 8949, *Sales and Other Dispositions of Capital Assets.* Code "W" should be entered in column (f) and the nondeductible loss should be entered as a positive number in column (g).[47]

[47] Instructions for Form 8949.

Scenarios 8A, B, and C Reporting. Sally's 2018 activity related to the Peppy, Sprightly, and SMI stocks is shown on the following 2018 Form 8949.

Form **8949** Department of the Treasury Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Go to *www.irs.gov/Form8949* for instructions and the latest information.
▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074 **2018** Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number
Sally O'Malley	123-45-6789

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☒ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
300 sh. Peppy, Inc.	02/16/18	07/03/18	2,100	3,000	W	900	0
200 sh. Sprightly, Inc.	03/01/18	07/03/18	1,400	2,000			(600)
100 sh. Sprightly, Inc.	03/01/18	07/03/18	700	1,000	W	300	0
500 sh. Specific Motors, Inc	02/17/18	03/09/18	1,000	2,000	W	1,000	0

REAL PROPERTY[48]

Real property is generally defined as land and anything built on or attached to it. The basis of real property acquired by purchase is the amount paid for the real property plus certain fees and other expenses.

SETTLEMENT COSTS

The taxpayer's basis includes settlement fees and closing costs for buying property but does not include the fees and costs for obtaining a loan on the property. The following nonexclusive list of settlement fees and closing costs are included in the property's basis.

- Abstract fees
- Charges for installing utility services
- Legal fees including title search and preparation of sales contract and deed

48. IRS Pub. 551, *Basis of Assets.*

- Recording fees
- Surveys
- Transfer taxes
- Owner's title insurance
- Amounts the seller owes that the buyer agrees to pay (e.g., back taxes, interest, recording or mortgage fees, charges for repairs or improvements, and sales commissions)

Some of the settlement fees and closing costs that a taxpayer cannot include in the property's basis include the following.

- Casualty insurance premiums
- Rent for occupancy of the property before closing
- Charges for utilities or other services connected with occupancy of the property before closing
- Charges connected with obtaining a loan (e.g., points, mortgage insurance premiums, loan assumption fees, cost of credit report, appraisal fees)
- Mortgage refinancing fees

CAPITAL IMPROVEMENTS[49]

Improvements increase the value of real property, prolong its useful life, or adapt it to new uses. The cost of additions and improvements should be added to the basis of the real property.

CONSTRUCTING PROPERTY

When a taxpayer builds property or has assets built for them, the expenses for construction are part of the property's basis. Such expenses include the following costs.

- Land
- Labor and materials
- Architect's fees
- Building permits
- Payments to contractors
- Payments for rental equipment
- Inspection fees

If a taxpayer owns a business and uses their employees, material, and equipment to build an asset, the following costs must be included in the asset's basis.

- Employee wages paid for the construction work, reduced by any employment credits allowed
- Depreciation on equipment owned while it is used in the construction
- Operating and maintenance costs for equipment used in the construction
- Costs of business supplies and materials used in the construction

49. Ibid.

REAL ESTATE TAXES

If the buyer pays real estate taxes **that the seller owed** on the real property and the seller does not reimburse the buyer, these taxes are included in basis. The buyer cannot deduct such real estate taxes currently.

If the buyer reimburses the seller for taxes the seller paid, the buyer can generally deduct that amount as an expense in the year of purchase. Therefore, this amount is not included in the property's basis. If the buyer does not reimburse the seller, the buyer must reduce their basis by the amount of the taxes.

DEDUCTING OR CAPITALIZING COSTS

Costs that can be deducted as current expenses should not be added to basis. However, a taxpayer can choose to deduct or capitalize certain other costs. If a taxpayer elects to capitalize such costs, they are included in basis. The costs that a taxpayer can elect to capitalize include carrying charges, such as interest and taxes, that the taxpayer pays to carry or develop real property, or to carry, transport, or install personal property. Certain carrying charges must be capitalized under the uniform capitalization rules of IRC §263A.[50]

Note. For more information about deducting or capitalizing costs, see IRS Pub. 535, *Business Expenses.*

A taxpayer makes the election to capitalize a carrying charge by attaching a statement to their original tax return for the year the election is to be effective, indicating the charges they are electing to capitalize. However, if the taxpayer timely filed the return without making the election, they can still make the election by filing an amended return within six months of the return's due date (excluding extensions). The taxpayer should attach the statement to the amended return and write "Filed pursuant to section 301.9100-2" on the statement.[51]

The taxpayer can make an election to capitalize tangible property **repairs and maintenance costs** paid in carrying on a trade or business. These expenses are treated as improvements to tangible property as long as the taxpayer treats these items as capital expenditures on their books and records. **This is an annual election and is not a change in accounting method.**[52]

The election is made by attaching a statement to a timely filed original tax return (including extensions).

The following is a sample of the election statement.

Section 1.263(a)-3(n) Election

The taxpayer hereby makes the election to capitalize repair and maintenance costs under §1.263(a)-3(n).

Bob T. Payer
#1 Big Spender Drive
Mytown, IL 12345
SSN: 333-44-5555

50. Treas. Reg. §1.266-1; IRS Pub. 551, *Basis of Assets;* IRS Pub. 535, *Business Expenses.*

51. IRS Pub. 535, *Business Expenses.*

52. Treas. Reg. §1.263(a)-3(n).

NONBUSINESS BAD DEBT[53]

To deduct a bad debt, the taxpayer must have **basis.** This means that they must have already included the amount in their income or loaned out their own cash.

> **Scenario 9 Facts.** Ferris is obligated to pay child support to his ex-wife, Millie. He stopped paying child support after losing his job. Can Millie claim a bad debt deduction for the unpaid child support?

A **business** bad debt is one that arises from operating a trade or business and is deductible as a business loss. All other bad debts are **nonbusiness** bad debts and are deductible as short-term capital losses on Form 8949.

A taxpayer may be able to deduct the amount owed to them in the year the debt becomes worthless. To be deductible, nonbusiness bad debts must be completely worthless. A debt becomes worthless when there is no longer any chance that the debtor will pay the amount owed. A taxpayer cannot deduct a nonbusiness debt that is only partly worthless.

The taxpayer must be able to show that they intended to make a loan and not a gift at the time of the transaction. For example, if a taxpayer lends money to a friend or relative with the understanding that it may not be repaid, it is considered a gift, rather than a loan. Therefore, the taxpayer cannot take a bad debt deduction. A bad debt does not exist unless there is a valid creditor-debtor relationship between the taxpayer and the person or organization that owes the money.

> **Scenario 9 Discussion.** Millie cannot claim a bad debt deduction for the child support owed by Ferris. She has no basis in the unpaid child support because she did not report the obligation in her income.

> **Note.** For more information about the deductibility of bad debts, see IRS Pub. 550.

OTHER BASIS SITUATIONS

INHERITED PROPERTY[54]

Generally, taxpayers who inherit assets obtain a tax basis equal to the FMV at the time of the decedent's death. All taxpayers who inherit qualified property get this step up in basis.[55] **Qualified property** includes property **other than:**[56]

- Property that constitutes a right to receive an item of income in respect of a decedent (IRD),
- Certain restricted stock options, and
- Property acquired from certain decedents who died in 2010.

The beneficiary's tax basis is generally equal to the FMV at the time of death, which is determined by an appraisal or the best information available. The executor of an estate may choose to use the FMV on the date of death or on the **alternate valuation date.** The alternate valuation date is the date that is exactly six months after the date of death. The alternate valuation election may only be made if it lowers the overall value of the estate, lowers the estate tax, and is used for all assets in the estate. If the executor makes an alternate valuation date election, the beneficiary's basis is equal to the FMV of the property as of the alternate valuation date.[57]

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53. IRS Pub. 550, *Investment Income and Expenses.*
54. IRS Pub. 559, *Survivors, Executors, and Administrators.*
55. IRC §1014(a).
56. Treas. Reg. §1.1014-1.
57. IRC §§1014(a) and 2032; Instructions for Form 706.

Practitioner Planning Tip

After the death of a property owner, the joint owner or beneficiary should get the property appraised. This is necessary to show the stepped-up basis (discussed later).

3

Income in Respect of a Decedent[58]

Not all inherited assets are considered qualified property. There is a significant exception for **IRD.** In general, IRD is income that a decedent was entitled to receive but that was not properly includable in the **decedent's final income tax return** under the decedent's method of accounting. Instead, this income must be reported as taxable income by the recipient.

IRD includes the following.[59]

1. All accrued income of a decedent who reported their income using the cash method of accounting
2. Income accrued solely because of the decedent's death in the case of a decedent who reported their income using the accrual method of accounting
3. Income to which the decedent had a contingent claim at the time of their death

The following are some examples of IRD for decedents who reported their income using the cash method.[60]

1. Unpaid wages that are payable to the decedent's estate
2. Uncollected interest on U.S. savings bonds
3. Income from installment agreements
4. Annuities, retirement plans, and IRAs

The IRD has the same character it would have had if the decedent had lived and received such amount. For example, if the IRD would have been a short-term capital gain if the decedent had lived, it is also included in the beneficiary's income as a short-term capital gain.[61]

Note. For more information about IRD, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Advanced Individual Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

58. IRC §691 and Treas. Reg. §1.691(a)-1(b).
59. Treas. Reg. §1.691(a)-1(b).
60. IRS Pub. 559, *Survivors, Executors, and Administrators.*
61. IRC §691.

Assets That May Receive Special Treatment

Decedent's Personal Residence. The basis of the decedent's personal residence is the FMV at the date of death. However, the tax treatment of the sale depends on how the estate holds or uses the former residence. Upon death, the house is considered a business, investment, or personal asset, based on its use.

Scenario 10 Facts. Scarlett was still living at home when she passed away on July 27, 2018. The estate's executor, Andrea, put the house on the market as soon as possible after disposing of Scarlett's personal property and making repairs. At the time Scarlett passed away, the FMV of the home was $80,000. Unfortunately, the septic system needed to be replaced before the house could be sold, so the estate paid $5,000 to have a new system installed.

On April 30, 2019, the house sold for $90,000. The realtor's commission and other costs of selling the house totaled $7,000. What is the estate's basis? What is the gain or loss for the sale of the house?

If the executor intends to sell the house, the residence is a capital asset held for investment. Therefore, any gain or loss is a capital gain or loss. Although the decedent would not have been able to deduct a loss on the sale of their personal residence, its use has changed the nature of the asset to an investment and therefore any capital loss on the sale may be deductible. The same is true if the estate converted the residence to rental property before selling it.

Scenario 10 Discussion. The executor intended to sell the house; therefore, the house is a capital asset held for investment. Accordingly, any gain or loss is a capital gain or loss. The estate's basis and **capital loss** for the house that Scarlett lived in at the time of her death are calculated as follows.

Selling price		$90,000
FMV on date of death	$80,000	
Improvements	5,000	
Costs of sale	7,000	
Total basis	$92,000	(92,000)
Net capital loss		($ 2,000)

Scenario 11 Facts. Bruce lived with his mother in the home she owned when she passed away. He is the sole beneficiary of her estate. At the time of her death, the FMV of the house was $130,000. Six months after her death, Bruce decided that he could not live alone anymore. He sold the house and moved in with his girlfriend. He managed to sell the house for $130,000, but he paid $10,000 in selling expenses. Is Bruce's $10,000 loss deductible?

The result is different if the house is **not** held for business or investment use. If it is sold without first converting it to business or investment use, any gain is a capital gain but a loss is **not deductible.**

Scenario 11 Discussion. Bruce's $10,000 loss is **not** deductible because the residence was held for his personal use, rather than for investment or business use.

Gifts of Appreciated Property. Appreciated property is property that had an FMV greater than its adjusted basis on the day it was transferred to the decedent.[62] There is a 1-year look-back period for gifts of appreciated property that are subsequently inherited by the person who made the gift. Property reacquired from the decedent does not receive a step up in basis. The beneficiary's basis is the same as the decedent's adjusted basis immediately before death.

Special-Use Valuation Property. IRC §2032A allows the executor of an estate to choose a special-use valuation of qualified small businesses and farm property. Instead of valuing the property at the FMV, the value is based on the continued use of the property by the family in the same activity as that of the decedent.

62. IRS Pub. 559, *Survivors, Executors, and Administrators.*

Real property used in a trade or business or a farm can be valued for estate tax purposes based on its use as a business property or farm instead of its FMV on the date of death or alternate valuation date if certain requirements are met.[63] The value of the real property as a business asset or farm asset may be very different than the property's FMV.

The maximum amount that property valued under §2032A can be reduced from its FMV is $1.16 million (for 2019).[64] This amount is subject to an annual adjustment for inflation.[65]

The alternate-valuation date election and the special-use valuation election may both be made for the same estate if the estate qualifies for both of the elections.[66] If both elections are made, the calculated value must reflect the value as of the alternate-valuation date.[67]

> **Note.** For further details on the requirements that a business property or farm must meet for the special-use valuation election, see IRC §2032A and related regulations.

Under certain conditions, some or all of the estate tax benefits obtained by using the special-use valuation are subject to recapture. Generally, an additional estate tax must be paid by a qualified heir if the property is disposed of, or is no longer used for a qualifying purpose, within 10 years of the decedent's death.[68]

If qualified heirs buy the property from the estate, their basis is equal to the special-use value reported by the estate plus any gain recognized by the estate. **Qualified heirs** include an ancestor, spouse, a lineal descendant of the decedent, a lineal descendant of the decedent's parent or spouse, or the spouse of any lineal descendant. If the heir must pay any additional estate tax, they can elect to increase their basis in the special-use valuation property to its FMV on the date of the decedent's death or on the alternate valuation date, if the alternate date was used for the estate return. If the heir elects to increase the basis, they must pay interest on the recapture tax for the period beginning nine months after the decedent's death until the date the recapture tax is paid.

> **Note.** For more information on the recapture tax, see the instructions for Form 706-A, *United States Additional Estate Tax Return.*

Jointly Held Property.

Scenario 12A Facts. Grayson and his sister Mauve own, as **joint tenants with right of survivorship**, rental property they purchased for $60,000. Mauve paid $15,000 (25%) of the purchase price, and Grayson paid $45,000 (75%). Even though Mauve and Grayson did not provide the same consideration for the purchase, the titling of the property as joint tenants with right of survivorship automatically makes them 50/50 owners. Grayson, has, in fact, made a gift to Mauve of $15,000 (($60,000 rental property cost ÷ 2 owners) – $15,000 Mauve paid).

Grayson died. At the time of his death, the FMV of the property was $100,000. The depreciation deductions allowed before Grayson's death totaled $20,000. What is Mauve's new basis in the property?

The surviving owner's new basis for jointly owned property is calculated by adding the survivor's basis in the property to the value of the inherited part of the property.

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63. IRC §2032A.
64. Rev. Proc. 2018-57, 2018-49 IRB 827.
65. IRC §2032A(a)(3).
66. Rev. Rul. 83-31, 1983-1 CB 225.
67. Rev. Rul. 88-89, 1988-2 CB 333.
68. IRC §2032A(c).

Scenario 12A Discussion. Mauve's new basis in the property is calculated as follows.

Half of cost basis (50% of $60,000)	$30,000
50% of depreciation allowed/allowable	(10,000)
Interest acquired from Grayson (50% of $100,000)	50,000
Mauve's new basis	$70,000

Observation. Mauve now has two items of depreciation to account for annually. Her original 50% ownership ($30,000) with the original acquisition date and the same accumulated depreciation ($10,000) she had been using and a new asset with a basis of $50,000 and a starting date (or acquisition date) for depreciation at Grayson's death. The depreciable bases in both cases make no allocation for the potential cost of land.

Scenario 12B Facts. Use the same facts as **Scenario 12A,** except Grayson and Mauve own the property as **tenants in common**. Grayson's will states that upon his death his interest in the rental property passes to Mauve. What is Mauve's new basis in the property?

Tenants in common ownership is generally designed to pass one party's ownership in property upon death to someone other than the party with whom the taxpayer was in business. The surviving owner's new basis for property owned as tenants in common is calculated by adding the survivor's basis in the property to the value of the inherited part of the property.

Scenario 12B Discussion. Mauve's new basis in the property is calculated as follows.

Mauve's original basis (25% of $60,000)	$15,000
25% of depreciation allowed/allowable	(5,000)
Interest acquired from Grayson (75% of FMV)	75,000
Mauve's new basis	$85,000

Observation. Mauve now has two items of depreciation to account for annually. Her original 25% ownership ($15,000) with the same acquisition date and same accumulated depreciation ($5,000) she had been using and a new asset with a basis of $75,000 and a starting point (or acquisition date) for depreciation at Grayson's death. The depreciable bases in both cases make no allocation for potential cost in land.

THE LIFE ESTATE/REMAINDER TRANSFER STRATEGY

The life estate/remainder arrangement is a form of co-ownership that gives both the life tenant and the person(s) holding the remainder interest certain rights to the property. The life tenant has a current right to possession, and the holder of the remainder interest has a right of possession upon the life tenant's death.[69] Therefore, the basis of the property is computed differently than the basis of property transferred through an inheritance.

Uniform Basis

The general idea of uniform basis is that the cost basis of inherited property should equal the value used for estate tax purposes.[70] The new cost basis after death is usually referred to as the **stepped-up basis.** As mentioned earlier, the basis of inherited property is usually the FMV of the property as of the decedent's date of death. The regulations state that the basis of property acquired from a decedent is uniform in the hands of every person having an interest in the property.[71]

69. IRC §2036; *Gifting of a Remainder Interest in a Home.* Kosty, Lauren. Nov. 1, 2007. AICPA. [www.thetaxadviser.com/issues/2007/nov/giftingofaremainderinterestinahome.html] Accessed on Jan. 10, 2019.

70. Treas. Reg. §1.1014-1(a).

71. Treas. Reg. §1.1014-4.

Scenario 13 Facts. Ben left his entire estate to his son, Samuel, as a remainder holder. However, all income from the estate was payable to his wife, Jennifer, until her death. The value of the property was $200,000 at the time of Ben's death.

Jennifer collected the income from the inherited property for 20 years. When she died, the appreciated value of the property was $500,000.

When Jennifer died, Samuel became the sole owner of both the property and the future income. What is Samuel's basis in the property?

The uniform basis rule is easy to implement after the death of the life tenant, as shown in **Scenario 13.**

Scenario 13 Discussion. Because Samuel's ownership of the property was based initially on his father's death, Samuel's basis is $200,000, the value at the time his father died.

Observation. This result can be explained by the **exclusion** of the life interest from Jennifer's estate. Because it was **not** includable in her estate, there was no step up in basis to Samuel, the person who received the right to the income after she died.

Scenario 14A Facts. Rhoda owned an apartment complex in downtown Minneapolis. She left a life interest in the apartments to her husband, Carlton, and the remainder interest to her best friend, Phyllis. When Rhoda died, the complex was valued at $900,000. This value is allocated $200,000 to land and $700,000 to buildings.

What is Carlton's basis in the property for depreciation purposes?

If the inherited property is subject to depreciation, the holder of the life interest is allowed to claim the depreciation expense attributable to the entire inherited basis of the depreciable property.[72]

Scenario 14A Discussion. As the holder of the life interest, Carlton is allowed to depreciate the entire inherited basis of the depreciable property. Therefore, his basis in the property for depreciation purposes during his lifetime is $700,000. This is true even though he is not the ultimate owner of the property.

Scenario 14B Facts. Use the same facts as **Scenario 14A,** except Carlton lived for 10 years and claimed a total of $250,000 in depreciation on the property. He died in 2019, and Phyllis acquired the complex. What is Phyllis's adjusted basis in the property?

The depreciation deductions allowed or allowable are an adjustment to the property basis in the hands of every person to whom the uniform basis is applicable.[73]

Scenario 14B Discussion. Phyllis's adjusted basis in the buildings at the time of Carlton's death is the same as Carlton's adjusted basis of $450,000 ($700,000 initial basis – $250,000 depreciation). Phyllis continues the depreciation after Carlton's death using Rhoda's date of death as the beginning date.

Scenario 15 Facts. In June 2012, Benson left a life interest in the income from his land in Peoria, Illinois, to Payne. He left the remainder interest in the land to Sybil. The land is valued at $10 million on Benson's estate tax return.

Payne and Sybil agree to sell the inherited land to Evan in exchange for $11 million. Payne is 55 years old at the time of the sale.

Payne and Sybil allocate the $10 million basis between them for income tax purposes. How is Payne's basis calculated? How is Sybil's basis calculated?

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72. Treas. Reg. §1.1014-4(b).

73. Ibid.

At any particular time, a life tenant's portion of the uniform basis is equal to the present value of the uniform basis, based on the life expectancy of the life tenant. The present value is calculated based on the factor found in table S in Treas. Reg. §20.2031-7. Table S shows the remainder factor. The life estate factor is calculated by subtracting the remainder factor from 1.00.[74] The remainder holder's basis is the difference between the uniform basis and the amount allocated to the life tenant.[75]

The relative value of the life interest and the remainder interest is determined under IRC §7520, using tables provided by the Treasury Department. The interest rate for a particular month is the rate that is 120% of the applicable federal midterm rate for the month in which the valuation date falls. That rate is rounded to the nearest two-tenths of 1%.[76]

Scenario 15 Discussion. Payne's basis is the present value of the uniform basis. For June 2012 (the valuation date), 120% of the applicable federal midterm rate is 1.28%. Rounded to two-tenths of 1%, the applicable rate is 1.2%.[77] The remainder factor for a person 55 years old at 1.2% is .74302, as shown in the following table found in Treas. Reg. §20.2031-7(d)(7). The life estate factor is 1.00 minus the remainder factor.[78] Accordingly, Payne reports a basis of $2.5698 million ($10 million uniform basis × (1.00 – 0.74302)) on his tax return against the sales price of his life interest.

Single Life Remainder Factors Applicable On or After May 1, 2009

	Interest Rate									
Age	**0.2%**	**0.4%**	**0.6%**	**0.8%**	**1.0%**	**1.2%**	**1.4%**	**1.6%**	**1.8%**	**2.0%**
53	.94717	.89767	.85126	.80772	.76687	.72852	.69249	.65863	.62680	.59687
54	.94878	.90070	.85555	.81313	.77326	.73577	.70050	.66730	.63603	.60658
55	.95037	.90371	.85983	.81853	.77964	.74302	.70851	.67598	.64530	.61635
56	.95195	.90670	.86406	.82388	.78599	.75024	.71651	.68465	.65457	.62613
57	.95351	.90965	.86827	.82920	.79230	.75744	.72448	.69332	.66384	.63593
58	.95505	.91257	.87243	.83447	.79857	.76459	.73242	.70195	.67309	.64573
59	.95657	.91546	.87655	.83970	.80479	.77170	.74033	.71057	.68233	.65553

Sybil's basis as the remainder holder is the difference between the uniform basis and the amount allocated to Payne. Therefore, she reports $7.4302 million as her cost basis ($10 million – $2.5698 million).

Sale of the Life Estate Interest

Scenario 16 Facts. Bing left a life interest in stock to his neighbor, Danny, and a remainder interest to another neighbor, Katherine. The value of the stock for estate tax purposes was $5,000 at the time Bing died. Danny immediately sold his life interest to Loretta for $1,000. What is Danny's basis in his life interest? How should Loretta treat the $1,000 she paid to Danny for tax purposes?

The basis rules change dramatically for the holder of a life estate interest if the rights to the income are sold without the remainder interest being sold as part of the same transaction. **If the life interest is sold separately, the seller's basis for tax purposes is $0.**[79]

74. Treas. Reg. §20.2031-7(d)(2)(iii).

75. Treas. Reg. §§20.2031-7(d)(2)(iii) and 20.2031-7(d)(5), Example 2.

76. IRC §7520; *Section 7520 Interest Rates for Prior Years.* IRS. [www.irs.gov/businesses/small-businesses-self-employed/section-7520-interest-rates-for-prior-years] Accessed on Jan. 11, 2019.

77. Ibid.

78. Treas. Reg. §20.2031-7(d)(2)(iii).

79. IRC §1001(e).

The buyer of the life interest can amortize the cost of the purchase over the life expectancy of the seller.[80]

Scenario 16 Discussion. Because Danny sold his life interest separately, his cost basis in the life interest was $0. This transaction has no effect on the uniform basis. The cost basis allocable to Katherine's remainder interest will continue to increase each year as the life interest's value decreases.

Loretta is entitled to subtract a portion of the $1,000 she paid Danny each year against her dividend income. The subtraction is based upon Danny's life expectancy at the time of the sale.[81]

GIFTED PROPERTY

Gifting Depreciated Property[82]

Scenario 17 Facts. Adam had some stock in Mytek Industries, Inc., which he purchased in 2013 for $20,000. He gifted this stock to his son, Zack, on September 14, 2016. On the date the gift was made, the FMV of the stock was $10,000. Zack sold the stock in 2019 for $15,000. Did Zack realize a gain or a loss? What was Zack's basis in the stock?

Generally, the donee's basis in property received as a gift for the purpose of calculating gain is equal to the donor's basis. However, if the value of the gifted property has declined in the donor's hands and the donor's basis is more than the FMV of the property at the time the gift is made, the FMV becomes the donee's basis for loss calculation.

Scenario 17 Discussion. Zack did not realize a gain **or** a loss. His basis for determining loss was $10,000 (i.e., the FMV at the time the gift was made); therefore, he had no loss when he sold the stock for $15,000. His basis for determining gain was $20,000 (i.e., Adam's basis); therefore, he had no gain.

Gifting Appreciated Property[83]

Scenario 18 Facts. In 2018, Carolee received a gift of property from her mother Althea that had an FMV of $50,000. Althea's adjusted basis was $20,000. The taxable amount of the gift for gift tax purposes was $35,000 ($50,000 – $15,000 annual exclusion).[84] In prior years, Althea exceeded her lifetime gift exclusion amount. Althea paid gift tax of $7,000. How is Carolee's basis calculated?

If property that has appreciated in value is gifted, a special rule allows the property's basis to be increased by the gift tax paid. However, the amount of the increase in basis is limited to the gift tax paid that is attributable to the net appreciation of the gifted property.[85] The net appreciation is the amount by which the date-of-gift FMV exceeds the donor's basis.[86]

The increase in basis is calculated by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in the gift's value and the denominator is the amount of the gift. The amount of the gift is its value for gift tax purposes after a reduction for any annual exclusion and marital or charitable deduction that applies to the gift.

80. Treas. Reg. §1.1014-5(a).
81. Treas. Reg. §1.1014-5(c).
82. Treas. Reg. §1.1015-1(a).
83. IRS Pub. 551, *Basis of Assets.*
84. Rev. Proc. 2017-58, 2017-45 IRB 489.
85. IRC §1015(d)(6)(A).
86. IRC §1015(d)(6)(B).

Scenario 18 Discussion. Carolee's basis is $25,999, which is calculated as follows.

FMV	$50,000
Less: adjusted basis	(20,000)
Net increase in value	$30,000
Divided by gift amount	÷ 35,000
Proportion of gift tax attributable to appreciation	.857
Gift tax paid	× $ 7,000
Gift tax due to net increase in value	$ 5,999
Adjusted basis of property to Althea	20,000
Carolee's basis	$25,999

Note. If the donor makes multiple gifts during the tax year, the gift tax basis adjustment amount is allocated to each gift on a pro-rata basis based on the size of each individual gift relative to the total taxable gifts made during the year. See Treas. Reg. §1.1015-5(c)(3) for additional guidance.

PROPERTY TRANSFERRED FROM A SPOUSE

Generally, a spouse (or former spouse if the transfer is incident to divorce) who receives property transferred to them or transferred in trust for their benefit by their spouse (or former spouse) has the same basis at their spouse's adjusted basis. However, the basis must be adjusted for any gain recognized by their spouse or former spouse on property transferred in trust. This rule only applies to a transfer of property in trust in which the liabilities assumed, plus the liabilities to which the property is subject, exceed the adjusted basis of the property transferred.[87]

Nonrecognition Rules

Scenario 19 Facts. Erica and Jackson finalized their divorce on December 31, 2018. Rather than selling their house and dividing the proceeds after the divorce, Jackson decides to purchase a second house with a value of approximately half of the home and transfers it to Erica before December 31, 2019.

How is Jackson's basis in the matrimonial home calculated? How is Erica's basis in the new house calculated?

Three basic nonrecognition rules apply to the transfer of property between spouses or incident to a divorce. These nonrecognition rules apply to **outright transfers** or **transfers in trust** incident to a divorce.

1. For transfers prior to the finalization of the divorce, no gain or loss is recognized on the transfer of property between spouses.[88]
2. For transfers after the divorce is finalized, no gain or loss is recognized on the transfer of property between former spouses if the transfer is incident to the divorce.[89]
3. The transfer is treated as a gift for income tax purposes. The spouse receiving the property takes the same basis as the transferor spouse even if the property is business property for which the receiving spouse paid the transferor spouse.[90] The receiving spouse also acquires the transferring spouse's holding period in the property.[91]

87. IRS Pub. 504, *Divorced or Separated Individuals.*
88. IRC §1041(a)(1).
89. IRC §1041(a)(2).
90. IRC §1041(b); Temp. Treas. Reg. §1.1041-1T.
91. Treas. Reg. §1.1250-3(a)(3)(ii).

A transfer is conclusively "incident to the divorce" if it occurs **within one year** after the ending date of the marriage or if it is made under a qualifying divorce or separation instrument and the transfer occurs not more than six years after the date on which the marriage ends.[92] Any transfer not made under a divorce or separation instrument and any transfer occurring more than six years after the end of the marriage is presumed to not be related to the end of the marriage. This presumption can be rebutted by showing that the transfer was made to effect the division of the property owned by the former spouses at the time the marriage ended.[93]

The transfer **must** be a transfer of property. Property generally includes **all** property, including real and personal property and tangible and intangible property.[94] In addition, these nonrecognition rules are applicable to property that was not owned by either spouse during the marriage.[95]

Scenario 19 Discussion. The transfer of the house from Jackson to Erica was within one year after their divorce. Therefore, the transfer is incident to the divorce. Accordingly, the nonrecognition rules prevent the triggering of any capital gain or loss to Jackson upon the transfer and he receives a carryover basis from Erica's half of the matrimonial home. Erica's basis in the new house received from Jackson also has a carryover basis equal to the amount Jackson paid for the house.

Nonrecognition Basis Rules.

Scenario 20A Facts. Dolly received some Kryler Motor Company stock as a gift from her friend Carl in 2015. On the date the gift was made, the stock had an FMV of $70,000. Carl's basis in the stock was $100,000. Dolly sells the Kryler stock in 2019 for $60,000. What is the amount of Dolly's basis and her loss on the sale of stock?

The nonrecognition rules treat a transfer of property incident to divorce as a **gift** for income tax purposes only. For subsequent dispositions, the carryover basis rule associated with the nonrecognition rules differs somewhat from that for gifting. For calculating a **gain,** divorce nonrecognition and gifting rules both use the transferor's basis.[96] For calculating a **loss using the gifting rules,** however, the **lesser of** the transferor's (donor's) basis or the FMV on the date of the transfer is used.[97] **For calculating a loss using the divorce nonrecognition rules, the transferor's basis is used.[98]**

Scenario 20A Discussion. The appropriate amount to use to calculate Dolly's loss on the sale of the stock she received as a **gift** from her **friend** Carl is the lesser of Carl's basis ($100,000) or the FMV of the stock on the date the gift was made ($70,000). Therefore, Dolly uses the $70,000 FMV to calculate her loss. Dolly's loss is $10,000 ($60,000 sale price − $70,000 FMV on date of gift).

Scenario 20B Facts. Use the same facts as **Scenario 20A,** except Carl was Dolly's former husband and she received the stock in accordance with the terms of their divorce decree. What is the amount of Dolly's basis and her loss on the sale?

Scenario 20B Discussion. Carl was Dolly's former husband and she received the stock in accordance with the terms of their divorce decree. Under the divorce nonrecognition rules, the appropriate basis to use in calculating Dolly's loss is $100,000, which is the carryover basis from Carl. Dolly's loss is therefore $40,000 ($60,000 sale price − $100,000 basis).

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92. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(b).

93. Temp. Treas. Reg. §1.1041-1T(b).

94. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(a).

95. Temp. Treas. Reg. §1.1041-1T(a).

96. IRC §1041(b).

97. IRC §1015(a).

98. Temp. Treas. Reg. §1.1041-1T(d).

Debt in Excess of Basis.

Scenario 21A Facts. Guy owns a **rental home** on which he claimed depreciation. His adjusted basis in the building is $100,000. The property is subject to a $130,000 mortgage. He transfers this property to his wife Sissy incident to their pending divorce. Does Guy recognize gain on the transfer? What is Sissy's basis in the property?

A property settlement may involve the transfer of property subject to a liability. As a general tax rule, if property with a cost basis less than its associated liabilities is transferred, the transferor must recognize gain by the amount the liabilities exceed the basis in the property.[99] However, under the divorce nonrecognition rules, no such gain or loss is recognized on a transfer of property incident to a divorce.[100] The transferee spouse takes the transferor spouse's basis in the property with no step up in basis for the assumed liability.[101]

Scenario 21A Discussion. Under the divorce nonrecognition rules, Guy does not recognize the $30,000 gain ($130,000 mortgage – $100,000 basis) on the transfer. Sissy has a carryover basis of $100,000 in the property. She does not get a basis step up for the assumed liability.

Transfers in Trust.

Scenario 21B Facts. Use the same facts as **Scenario 21A,** except instead of Guy transferring the property directly to Sissy, the property is transferred to a trust for the benefit of Sissy. Is Guy required to recognize any gain on the transfer? What is the trust's basis in the property?

Property may be transferred to a spouse or former spouse incident to divorce outright or in trust.[102] One or both spouses may prefer to use a trust if they want to ensure the property or income from the property passes to children or other beneficiaries after the death of one or both divorced spouses.

Generally, transfers in trust fall under IRC §1041(e) and do not result in any recognition of gain or loss to the transferor. However, there are exceptions to this general rule.[103] Gain or loss is recognized with:

1. A transfer of an installment obligation to a trust, or
2. A transfer of property in trust with debt in excess of basis.[104]

For transfers in trust, if the liability to which the property is subject plus any additional liabilities assumed by the transferee exceeds the basis in the property, this excess is the amount of gain that the **transferor** must recognize. The trust's basis in the property is increased by the recognized gain.[105]

Scenario 21B Discussion. Even though the transfer is still incident to a divorce, Guy is required to recognize $30,000 of gain on the transfer to the trust because the $130,000 mortgage exceeded the $100,000 basis. The trust's basis in the property is the $100,000 carryover basis increased by the $30,000 gain that Guy must recognize. Therefore, the trust's basis is $130,000.

Note. For a discussion of the rules that apply to divisions of property in community property states and additional exceptions to the nonrecognition rules, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5: Divorce.

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99. *Crane v. Comm'r*, 331 U.S. 1 (1947); *Comm'r v. Tufts*, 461 U.S. 300 (1983).
100. IRC §1041(a) and Temp. Treas. Reg. §1.1041-1T(d).
101. Temp. Treas. Reg. §1.1041-1T(d).
102. See IRC §1041.
103. IRS Pub. 504, *Divorced or Separated Individuals*.
104. Ibid.
105. Ibid.

LIKE-KIND EXCHANGES

Starting in 2018, like-kind exchange treatment is only available for real property.[106] Before 2018, the like-kind exchange rules also applied to depreciable tangible personal property and intangible and nondepreciable personal property.

The taxpayer recognizes no gain or loss when only like-kind property is exchanged and all other requirements are met.[107] In this case, the taxpayer's adjusted basis in the relinquished property carries over to the replacement property.[108]

Partial Like-Kind Exchanges[109]

Because the values of properties exchanged in a like-kind exchange rarely match, "boot" (cash and/or other property) is often also transferred to equalize the values of the surrendered and received properties. Boot sometimes includes debt relief.

Gain/Loss. The amount of gain or loss realized in a partial like-kind exchange is determined based on the general rule applicable to sales and exchanges. Under this rule, a gain is calculated as follows.

Gain = Sales proceeds – Adjusted basis of the property

Exchange expenses are subtracted from the sales proceeds in determining the amount realized. They are also subtracted from the boot received to determine any gain recognized. These expenses include such items as brokerage commissions, attorney fees, and deed preparation fees.

> **Scenario 22 Facts.** Leon exchanges a retail store with an FMV of $500,000 (adjusted basis of $350,000) and 1,000 shares of Pyramid Corp. (a publicly traded company) with an FMV of $50,000 and adjusted basis of $75,000 for a gas station with an FMV of $550,000. What is the amount, if any, of gain or loss that Leon recognizes on this transaction?
>
> What is Leon's basis in the gas station?

A loss results when the adjusted basis exceeds the sales proceeds (less exchange expenses). Generally, a loss is not deductible.[110] However, when a like-kind exchange includes boot consisting of other nonlike-kind property and a loss results, this loss is recognized to the extent that the adjusted basis of the nonlike-kind property exceeds its FMV on the exchange date.[111]

> **Scenario 22 Discussion.** Leon does not recognize gain on the exchange of the real estate because it qualifies as a nontaxable like-kind exchange. However, he recognizes (and reports on his return) a $25,000 capital loss ($50,000 FMV – $75,000 adjusted basis) on the boot consisting of 1,000 shares of Pyramid Corp. that he relinquished in the exchange.

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106. IRC §1031, as amended by PL 115-97.
107. IRC §1031(a).
108. IRC §1031(d).
109. IRS Pub. 544, *Sales and Other Dispositions of Assets*.
110. IRC §1031(c).
111. Treas. Reg. §1.1031(d)-1(e).

Basis of Property Received.[112] The total basis for all properties (other than money) received in a partially nontaxable exchange is the total adjusted basis of the properties surrendered, with the following adjustments.

Additions:

- Exchange expenses incurred
- Gain recognized

Subtractions:

- Money received
- Loss recognized on the exchange

This basis is first allocated to nonlike-kind property, other than money, up to its FMV on the date of the exchange. The remainder is the basis of the like-kind property.

Scenario 22 Discussion. Leon's basis in the gas station is determined as follows.

Adjusted basis of retail store surrendered	$350,000
Adjusted basis of stock surrendered	75,000
Plus: exchange expenses	0
Plus: gain recognized	0
Less: money received	0
Less: loss recognized	(25,000)
Adjusted basis of gas station received	$400,000

Depreciation Recapture. When depreciable property is disposed of, some or all of the realized gain may need to be recaptured as ordinary income. Gain is recharacterized as ordinary income to the extent of depreciation deductions that were allowed or allowable on the property. These rules are set forth in IRC §1245 for personal property and in IRC §1250 for real property.

Personal Property.[113]

Scenario 23. In 2018, Abby swaps an automobile for a truck owned by Carly. No other cash or property is exchanged. Both vehicles are 100% used in the taxpayers' respective business activities and have an FMV of $15,000. Abby's automobile originally cost $30,000. Its adjusted basis is $4,000 ($30,000 cost – $26,000 depreciation allowed) and its recomputed basis is $30,000 ($4,000 adjusted basis + $26,000 depreciation allowed).

What is Abby's adjusted basis in the truck she received in the exchange? What is her gain on the trade?

As mentioned earlier, personal property transactions no longer qualify for like-kind exchange treatment.

The exchange of tangible personal property subject to the allowance for depreciation results in depreciation recapture. Generally, the amount of this depreciation recapture is the amount by which the **lower** of the following amounts **exceeds the adjusted basis of the property.**

1. The recomputed basis of the property
2. The amount realized

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112. IRC §1031(d); IRS Pub. 544, *Sales and Other Dispositions of Assets*.

113. IRC §1245.

The recomputed basis is determined by adding back the following **allowed** or **allowable** depreciation deductions to the adjusted basis.

- Ordinary depreciation deductions
- Bonus depreciation
- Amortization
- IRC §179 deduction
- Certain special deductions claimed[114]
- Certain tax credit basis reductions[115]

However, depreciation **allowed** can be used when it can be established (by adequate records or other sufficient evidence) that the amount allowed was less than the depreciation amount allowable. For example, depreciation claimed using a proper depreciation method is not increased when a greater depreciation amount would have been allowed under another proper method.

The basis of property acquired in an exchange is usually its FMV at the time of the exchange.[116]

Scenario 23 Discussion. Abby has a realized and recognized gain of $11,000 on the exchange ((lesser of $30,000 recomputed basis or $15,000 FMV of truck received) – $4,000 adjusted basis). The entire $11,000 gain is ordinary because it is attributable to depreciation recapture. Abby reports this $11,000 ordinary gain on Form 4797, *Sale of Business Property*.

Abby's adjusted basis in the truck received in the exchange is $15,000 (its FMV).

> **Note.** For detailed information about exchanges of depreciable personal property, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

Real Property.[117] When gain is recognized on a like-kind exchange of depreciable real property, the amount of the gain recharacterized as ordinary income (due to depreciation recapture) is the greater of the following.

- Gain recognized under the like-kind exchange rules
- The excess of recapture income over the FMV of the acquired depreciable real property

The basis of acquired property is determined in accordance with the basis rules for like-kind exchanges discussed earlier.

Scenario 24 Facts. Aaron exchanges depreciable real property with a basis of $1.6 million and recapture income of $140,000 for depreciable real property with an FMV of $1.4 million, land with an FMV of $250,000, and stock with an FMV of $100,000.

Aaron's **amount realized** is $1.75 million ($1.4 million real property + $250,000 land + $100,000 stock). His **gain realized** is $150,000 ($1.75 million amount realized − $1.6 million basis of real property surrendered).

His **gain recognized** is $100,000 (the lesser of the $150,000 gain realized and the $100,000 FMV of the stock (total boot received).

How much recapture income must Aaron recognize? What is Aaron's basis in the stock, depreciable real property, and the land?

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114. See IRS Pub. 544, *Sales and Other Dispositions of Assets.*
115. Ibid.
116. IRS Pub. 551, *Basis of Assets.*
117. IRC §1250(d)(4); Treas. Reg. §1.1250-3; IRS Pub. 544, *Sales and Other Dispositions of Assets*.

When the taxpayer acquires both depreciable real property and other property in a like-kind exchange, basis is allocated between each class of property in proportion to their respective FMVs. However, for purposes of this allocation, the FMV of the depreciable real property is reduced by the amount of recapture income not recognized in the exchange.[118] If the taxpayer acquires more than one item of depreciable real property in the exchange, the basis is allocated between those properties in proportion to their relative FMVs.

When recapture income is not recognized in a like-kind exchange of depreciable real property, the amount of the unrecognized gain is considered additional depreciation that reduces the basis of the acquired depreciable real property (for purposes of a future disposition of the acquired property). When multiple depreciable real properties are acquired in the exchange, the additional depreciation is allocated to these depreciable real properties in proportion to their respective adjusted bases.

Scenario 24 Discussion. Absent the like-kind exchange rules, Aaron has recapture income of $140,000 that would be fully recognized. Instead, he recognizes recapture income of only $100,000, which is the **greater** of the following.

1. $100,000 gain recognized under the like-kind exchange rules
2. The excess of $140,000 recapture income over $1.4 million FMV of acquired depreciable property = $0 (the excess cannot be less than zero)

The $50,000 balance of the $150,000 gain realized ($40,000 of which is recapture income) is not recognized.

The aggregate basis of the assets Aaron received is $1.7 million ($1.6 million basis of the relinquished property + $100,000 recognized gain). The FMV of the stock (boot) is $100,000 and the boot takes an FMV basis. This leaves $1.6 million of basis to be allocated to the depreciable real property and the land in proportion to their respective FMVs. However, the FMV of the depreciable real property must first be reduced by the amount of the recapture income not recognized, which results in an adjusted FMV of $1.36 million ($1.4 million – $40,000). Accordingly, basis is allocated among the three assets received as follows.

Asset	FMV	Allocation Based on Adjusted FMV	Basis
Stock (FMV basis)	$ 100,000	$ 100,000	$ 100,000
Depreciable real property	1,360,000	($1,360,000 ÷ $1,610,000) × $1,600,000	1,351,553
Land	250,000	($250,000 ÷ $1,610,000) × $1,600,000	248,447
	$1,710,000		$1,700,000

Note. For a thorough explanation of the rules for like-kind exchanges, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

Taxable Exchange[119]

Scenario 25 Facts. Geneva trades an office building that has an adjusted basis of $100,000 for a piece of equipment that has an FMV of $115,000. How much, if any, is Geneva's taxable gain? What is her basis for the equipment?

A taxable exchange is defined as one in which a gain or loss is recognized. This means that any gain is taxable or any loss is deductible. In a taxable exchange, the basis of property the taxpayer receives is usually its FMV at the time of the exchange. A taxable exchange occurs when the taxpayer receives cash or property that is not similar or related in use to the property exchanged.

118. Treas. Reg. §1.1250-3(d)(2)(iii).

119. IRS Pub. 551, *Basis of Assets.*

Scenario 25 Discussion. Geneva's exchange is taxable because she exchanged real property for equipment. She must report a taxable gain of $15,000 ($115,000 FMV − $100,000 adjusted basis) for the building. Geneva's basis for the equipment is $115,000, which is its FMV.

Exchanges of depreciable tangible personal property and intangible and nondepreciable personal property occurring before January 1, 2018, qualified for nonrecognition treatment.[120] However, after December 31, 2017, such exchanges are taxable.[121]

PROPERTY CONVERTED FROM PERSONAL TO BUSINESS USE[122]

Depreciation Basis

Scenario 26A Facts. In 2010, Kammie paid $160,000 to have a home built on a lot that cost $30,000. She later paid $20,000 for improvements to the house. In 2019, she converts the house to rental use when the property's FMV is $200,000 ($165,000 for the house + $35,000 for the land). What is the property's depreciation basis?

If a taxpayer uses property for personal purposes and then converts it to business or rental use, it is necessary to calculate the property's depreciation basis. The depreciation basis is the **lesser** of the following amounts.

- The property's FMV on the conversion date
- The taxpayer's adjusted basis on the conversion date

Scenario 26A Discussion. The cost of the lot is not depreciable, so Kammie's basis for depreciation of the house is the lesser of the following amounts.

- FMV of $165,000 on conversion date
- Adjusted basis of $180,000 ($160,000 cost + $20,000 improvements) on conversion date

Therefore, Kammie's depreciation basis for the house is $165,000.

Basis for Sale or Disposal

When a taxpayer sells or disposes of property that was converted from personal to business or rental use, the property's basis depends on whether the taxpayer has a gain or a loss.

Scenario 26B Facts. Use the same facts as **Scenario 26A,** except Kammie sold the property for a gain after she took allowable depreciation deductions of $35,000. What is Kammie's basis for calculating the gain?

Scenario 26C Facts. Use the same facts as **Scenario 26A,** except Kammie sold the property for a loss after she took allowable depreciation deductions of $35,000. What is her basis for calculating the loss?

Gain. The taxpayer's basis for calculating a gain is their adjusted basis.

Scenario 26B Discussion. Kammie's adjusted basis for calculating the gain is $175,000 ($180,000 adjusted basis of house on conversion date – $35,000 depreciation + $30,000 basis of land).

Loss. The calculation of a taxpayer's basis for a loss begins with the **lesser** of the following amounts.

- The taxpayer's adjusted basis on conversion date
- The property's FMV at the time the property was converted to business or rental use

120. Treas. Regs. §§1.1031(a)-1 and 1.1031(a)-2.

121. IRC §1031(a)(1) as amended by PL 115-97.

122. IRS Pub. 551, *Basis of Assets.*

This amount is then adjusted for the period after the change in the property's use.

Scenario 26C Discussion. Kammie's basis for calculating the loss starts with determining the lesser of the following amounts.

- The adjusted basis on the conversion date, which is $210,000 ($160,000 cost of home + $20,000 improvements + $30,000 land)
- The property's FMV on the conversion date, which is $200,000

The lesser of these amounts is the FMV of $200,000, which is then adjusted for the depreciation deductions taken after the conversion date. Accordingly, the property's basis for calculating a loss is $165,000 ($200,000 – $35,000 depreciation).

SALE OF PRINCIPAL RESIDENCE

Scenario 27 Facts. Julia, a single taxpayer, bought property on January 1, 2005, for $400,000, and used it as rental property for 10 years, claiming $102,148 of depreciation deductions (thereby reducing her basis in the property to $297,852). On January 1, 2015, she began using the property as her principal residence. On January 2, 2019, Julia moved out of the home and sold it for $700,000, for a gain of $402,148 ($700,000 − $297,852 adjusted basis).

Julia's ownership of the property is summarized as follows.

1. Julia owned the property for a total of 14 years.
2. Julia used the property as a rental property for 10 years (four of which were prior to January 1, 2009).
3. Julia used the property as her principal residence for four years.
4. Julia has $102,148 of depreciation deductions allowed or allowable.
5. Julia's total gain upon the sale is $402,148.

Can Julia exclude $250,000 of gain under IRC §121?

After the enactment of the Housing Assistance Tax Act of 2008,[123] for sales and exchanges of a principal residence after December 31, 2008, IRC §121(a) provides that a gain from the sale of a principal residence up to $250,000 ($500,000 for married couples filing jointly) is excluded from gross income if the property is owned and used as the taxpayer's principal residence for at least two years during the 5-year period ending on the date of the sale or exchange. However, this **does not apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use.[124]**

Generally, **nonqualified use** is **any period** (**other than the portion of any period before January 1, 2009**) during which the property is not used as the principal residence of the taxpayer or spouse.[125]

For determining the amount of gain that is allocated to periods of nonqualified use, gain is allocated to periods of nonqualified use based on the following ratio.

- The aggregate periods of nonqualified use during the period the property was owned by the taxpayer, divided by
- The period the property was owned by the taxpayer.[126]

123. PL 110-289.

124. IRC §121(b)(5), as amended by PL 110-289.

125. IRC §121(b)(5)(C)(i).

126. IRC §121(b)(5)(B).

The numerator does **not include any period before January 1, 2009.**[127] However, the denominator (i.e., the period that the taxpayer owned the property) includes **all** periods of ownership (even those before January 1, 2009).

Scenario 27 Discussion. Prior to enactment of the Housing Assistance Tax Act, Julia would have had \$102,148 of gain attributable to depreciation deductions included in income (taxed at 25% as unrecaptured §1250 gain),[128] and could have excluded \$250,000 of her gain under IRC §121 (because she had two full years of ownership and use as her principal residence). The \$50,000 (\$402,148 total gain – \$102,148 depreciation deductions – \$250,000 exclusion) balance of her long-term gain would have been taxed at capital gains rate applicable to her in the year of sale.

Under the provisions of the Housing Assistance Tax Act, the \$102,148 gain attributable to Julia's depreciation deductions is included in income and taxed the same as it would have been under the old law (25% maximum unrecaptured §1250 gains rate). Of the remaining \$300,000 gain, 42.86% (6 years (10 years total nonqualified use – 4 years prior to January 1, 2009) nonqualified use ÷ 14 years total ownership), or \$128,580, is allocated to nonqualified use and is not eligible for the exclusion. This is taxed at long-term capital gains rate applicable to Julia in the year of sale. The remaining gain of \$171,420 (\$402,148 total gain – \$102,148 depreciation deductions – \$128,580 nonqualified use) is excluded under §121, because it is less than the maximum excludable gain of \$250,000.

Observations

1. Neither the basis of the property nor the amount of gain were impacted by the Housing Assistance Tax Act; only the tax treatment of the gain changed.
2. If Julia is in the 15% capital gains tax bracket, the change enacted by the Housing Assistance Tax Act cost her \$11,787 (15% assumed long-term capital gains rate × \$78,580 (\$50,000 taxable gain under previous law – \$128,580 taxable gain after the law change).
3. Taxpayers in a similar situation may find it advantageous to hold on to their property longer because additional years of ownership and use increase the ownership period (denominator of fraction) and thereby decrease the percentage amount not excludable under §121.

The basis and the taxable depreciation recapture did not change because of the enactment of the Housing Assistance Tax Act. Depreciation recapture is not eliminated unless the taxpayer dies and a beneficiary receives a new basis, free of depreciation recapture, equal to the FMV at the time of the taxpayer's death.

INSTALLMENT SALE BASIS[129]

An installment sale occurs when the seller receives at least one payment after the tax year of the sale. The seller cannot use the installment method to report a loss. A seller that realizes a gain on an installment sale may be able to report part of their gain when they receive each payment.

Scenario 28 Facts. Keegan sells property for \$60,000. The buyer will pay Keegan in installments. Keegan's adjusted basis is \$45,000.

What is Keegan's **contract price?** What is his **gross profit percentage?** How much of each payment must Keegan report as **installment sale income?**

127. IRC §121(b)(5)(C)(i).

128. IRC §§1(h)(1)(E) and (6)(A).

129. IRS Pub. 537, *Installment Sales.*

Each installment payment usually consists of three parts.

1. Interest income
2. Gain on the sale
3. Return of taxpayer's adjusted basis in the property

For installment sale purposes, **adjusted basis** is the total of the following items.

- Adjusted basis in the property — The adjusted basis is calculated as explained earlier in this chapter.
- Selling expenses — Selling expenses include commissions, attorney fees, and any other expenses paid on the sale of the property.
- Depreciation recapture — If the property sold was depreciable property, part of the gain on the sale may need to be recaptured as ordinary income.

To calculate the **gross profit** that the taxpayer reports on the installment method, the adjusted basis is subtracted from the selling price. A certain percentage of each payment (after deducting interest) is reported as installment sale income. This percentage is called the **gross profit percentage** and is calculated by dividing the gross profit from the sale by the contract price. The **contract price** is composed of:

- The selling price, minus
- The mortgages and other liabilities assumed by the buyer, plus
- The amount by which the mortgages and other liabilities assumed by the buyer exceed the taxpayer's adjusted basis.

Scenario 28 Discussion. The buyer did not assume any liabilities, so Keegan's **contract price** is the same as his selling price, or $60,000. His adjusted basis is $45,000; therefore, his gross profit is $15,000. Keegan's **gross profit percentage** is 25% ($15,000 gross profit ÷ $60,000 contract price).

After subtracting interest, Keegan reports 25% of each payment as **installment sale income** for the tax year he receives the payment. The remainder of each payment is the tax-free return of Keegan's adjusted basis.

Note. For detailed information about installment sales, see IRS Pub. 537, *Installment Sales.*

REPOSSESSION[130]

If a taxpayer repossesses property after making an installment sale, they must calculate the following amounts.

- Gain (or loss) on the repossession
- Basis in the repossessed property

The rules for calculating these amounts depend on the kind of property the taxpayer repossesses. The rules for repossessions of personal property differ from those for real property. Special rules may apply if the taxpayer repossesses property that was their main home before the sale.[131] The repossession rules apply regardless of whether title to the property was ever transferred to the buyer. It does not matter how the taxpayer repossesses the property, whether they foreclose or the buyer voluntarily surrenders the property to the taxpayer. However, it is not a repossession if the buyer puts the property up for sale and the taxpayer repurchases it.

130. IRS Pub. 537, *Installment Sales.*

131. See Treas. Reg. §1.1038-2 for further information.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to the taxpayer. The discharged obligation must be secured by the property the taxpayer repossesses. This requirement is met if the property is auctioned off after the foreclosure and the taxpayer applies the installment obligation to their bid price at the auction.

Reporting the Repossession

The taxpayer reports gain or loss from a repossession on the same form they used to report the original sale. If the taxpayer reported the sale on Form 4797*,* they also use it to report the gain or loss on the repossession.

Personal Property

If the taxpayer repossesses personal property, they may have a gain or a loss on the repossession. In some cases, they also may have a bad debt.

To calculate the gain or loss, the total of the taxpayer's basis in the installment obligation and any repossession expenses they have is subtracted from the FMV of the property. If the taxpayer receives anything from the buyer besides the repossessed property, its value is added to the property's FMV before making this calculation.

How the taxpayer's basis in the installment obligation is calculated depends on whether or not they reported the original sale on the installment method. The method they used to report the original sale also affects the character of their gain or loss on the repossession.

Installment Method Not Used to Report Original Sale. The following paragraphs explain how to calculate basis in the installment obligation and the character of any gain or loss if the taxpayer did not use the installment method to report the gain on the original sale.

Basis in Installment Obligation. The taxpayer's basis is calculated on the obligation's full face value or its FMV at the time of the original sale, whichever was used to calculate the taxpayer's gain or loss in the year of sale. From this amount, all payments of principal the taxpayer received on the obligation are subtracted. The result is the taxpayer's basis in the installment obligation. If only part of the obligation is discharged by the repossession, the taxpayer's basis in only that part is calculated.

Gain or Loss. Any repossession costs are added to the taxpayer's basis in the obligation. If the FMV of the property they repossess is more than this total, the taxpayer has a gain. This is gain on the installment obligation; therefore, it is all ordinary income. If the FMV of the repossessed property is less than the total of the taxpayer's basis plus repossession costs, the taxpayer has a loss. The taxpayer included the full gain in income in the year of sale, so the loss is a bad debt. How the taxpayer deducts the bad debt depends on whether they sold business or nonbusiness property in the original sale.

> **Note.** Nonbusiness bad debts are discussed earlier in this chapter. For more information, see chapter 4 of IRS Pub. 550 for information on nonbusiness bad debts and chapter 10 of IRS Pub. 535 for information on business bad debts.

Installment Method Used to Report Original Sale. The following paragraphs explain how to calculate the taxpayer's basis in the installment obligation and the character of any gain or loss if the taxpayer used the installment method to report the gain on the original sale.

Basis in Installment Obligation. To calculate the taxpayer's basis in the installment obligation, multiply the unpaid balance of their installment obligation by their gross profit percentage. This amount is subtracted from the unpaid balance. The result is the taxpayer's basis in the installment obligation.

> **Note.** Installment sales are discussed in more detail earlier in this chapter.

Gain or Loss. If the FMV of the repossessed property is more than the total of the taxpayer's basis in the obligation plus any repossession costs, they have a gain. If the FMV is less, they have a loss. The taxpayer's gain or loss on the repossession is of the same character (capital or ordinary) as their gain on the original sale.

The following worksheet from IRS Pub. 537, *Installment Sales,* can be used to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

Worksheet C. **Figuring Gain or Loss on Repossession of Personal Property**

Note. Use this worksheet only if you used the installment method to report the gain on the original sale.

Keep for Your Records

1.	Enter the FMV of the repossessed property		________
2.	Enter the unpaid balance of the installment obligation	________	
3.	Enter your gross profit percentage for the installment sale	________	
4.	Multiply line 2 by line 3. This is your unrealized profit	________	
5.	Subtract line 4 from line 2. This is the basis of the obligation		________
6.	Enter your costs of repossessing the property		________
7.	Add lines 5 and 6		________
8.	Subtract line 7 from line 1. This is your gain or loss on the repossession		________

> **Note.** This worksheet should be used only if the installment method was used to report the gain on the original sale.

Scenario 29. Casie sold her piano for $1,500 in December 2018 for $300 down and $100 a month (plus interest). The payments began in January 2019. Her gross profit percentage is 40%. She reported the sale on the installment method on her 2018 income tax return. After the fourth monthly payment, the buyer defaulted on the contract (which has an unpaid balance of $800) and Casie is forced to repossess the piano. The FMV of the piano on the date of repossession is $1,400. The legal costs of foreclosure and the expense of moving the piano back to Casie's home total $75. Casie calculates her gain on the repossession using the following worksheet.

Worksheet C. **Figuring Gain or Loss on Repossession of Personal Property**

Note. Use this worksheet only if you used the installment method to report the gain on the original sale.

Keep for Your Records

1.	Enter the FMV of the repossessed property		**$1,400**
2.	Enter the unpaid balance of the installment obligation	**$800**	
3.	Enter your gross profit percentage for the installment sale	**40%**	
4.	Multiply line 2 by line 3. This is your unrealized profit	**$320**	
5.	Subtract line 4 from line 2. This is the basis of the obligation		**$480**
6.	Enter your costs of repossessing the property		**$75**
7.	Add lines 5 and 6		**$555**
8.	Subtract line 7 from line 1. This is your gain or loss on the repossession		**$845**

Basis in Repossessed Property. The taxpayer's basis in repossessed personal property is its FMV at the time of the repossession.

FMV of Repossessed Property. The FMV of repossessed property is a question of fact to be established in each case. If the taxpayer bids for the property at a lawful public auction or judicial sale, its FMV is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

Real Property

The rules for the repossession of real property allow the taxpayer to keep essentially the same adjusted basis in the repossessed property they had before the original sale. They can recover this entire adjusted basis when they resell the property. This, in effect, cancels out the tax treatment that applied to the taxpayer on the original sale and puts them in the same tax position they were in before that sale.

As a result, the total payments the taxpayer received from the buyer on the original sale are considered income to them. The taxpayer reports, as gain on the repossession, any part of the payments they have not yet included in income. These payments are amounts they previously treated as a return of their adjusted basis and excluded from income. However, the total gain they report is limited. See the section "Limit on Taxable Gain," later.

Mandatory Rules. The rules concerning basis and gain on repossessed real property are mandatory. The taxpayer must use them to calculate their basis in the repossessed real property and their gain on the repossession. They apply regardless of whether the taxpayer reported the sale on the installment method. However, they apply only if all of the following conditions are met.

1. The repossession must be to protect the taxpayer's security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. The taxpayer did not pay any additional consideration to the buyer to get their property back unless either of the following situations applies.
   a. The requisition and payment of the additional consideration were provided for in the original contract of sale.
   b. The buyer has defaulted, or default is imminent.

Additional consideration includes money and other property the taxpayer pays or transfers to the buyer. For example, additional consideration is paid if the taxpayer reacquires the property subject to a debt that arose after the original sale.

If any one of the three conditions is not met, use the rules discussed earlier for repossessions of personal property, **as if** the property the taxpayer repossesses were personal rather than real property. **Do not** use the rules for real property.

Calculation Gain on Repossession. The taxpayer's gain on repossession is the difference between the following amounts.

- The total payments received, or considered received, on the sale.
- The total gain already reported as income.

Limit on Taxable Gain. Taxable gain is limited to the taxpayer's gross profit on the original sale minus the sum of the following amounts.

- The gain on the sale the taxpayer reported as income before the repossession
- The repossession costs

This method of calculating taxable gain, in essence, treats all payments received on the sale as income but limits the taxpayer's total taxable gain to the gross profit they originally expected on the sale.

Indefinite Selling Price. The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price stated as a percentage of the profits to be realized from the buyer's development of the property is an indefinite selling price.

Character of Gain. The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if the taxpayer did not report the sale on the installment method, the gain is ordinary income.

Repossession Costs. The taxpayer's repossession costs include money or property they pay to reacquire the real property. This includes amounts paid to the buyer of the property, as well as amounts paid to others for items such as those listed below.

- Court costs and legal fees
- Publishing, acquiring, filing, or recording of title
- Lien clearance

Repossession costs do not include the FMV of the buyer's obligations to the taxpayer that are secured by the real property or the costs of reacquiring those obligations.

The following worksheet from IRS Pub. 537 can be used to determine the taxable gain on a repossession of real property reported on the installment method.

Worksheet D. **Taxable Gain on Repossession of Real Property**

Note. Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.

Keep for Your Records

1.	Enter the total of all payments received or treated as received before repossession	______
2.	Enter the total gain already reported as income	______
3.	Subtract line 2 from line 1. This is your gain on the repossession	______
4.	Enter your gross profit on the original sale	______
5.	Enter your costs of repossessing the property	______
6.	Add line 2 and line 5	______
7.	Subtract line 6 from line 4	______
8.	Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession	______

Note. This worksheet is used to determine taxable gain on the repossession of real property if the taxpayer used the installment method to report the gain on the original sale.

Scenario 30. Linn sold a tract of land in January 2018 for $25,000. He accepted a $5,000 down payment, plus a $20,000 mortgage secured by the property and payable at the rate of $4,000 annually plus interest at 9.5%. The payments began on January 1, 2019. Linn's adjusted basis in the property was $19,000 and he reported the transaction as an installment sale. His selling expenses were $1,000. Linn calculated his gross profit as follows.

Selling price		$25,000
Less:		
Adjusted basis	$19,000	
Selling expenses	1,000	
	$20,000	(20,000)
Gross profit		$ 5,000

For this sale, the contract price equals the selling price. The gross profit percentage is 20% ($5,000 gross profit ÷ $25,000 contract price).

In 2018, Linn included $1,000 in income (20% × $5,000 down payment). In 2019, he reported a profit of $800 (20% × $4,000 annual installment). In 2019, the buyer defaulted and he repossessed the property. He paid $500 in legal fees to get the property back. Linn's taxable gain on the repossession is calculated as follows, using the worksheet from IRS Pub. 537.

Worksheet D. **Taxable Gain on Repossession of Real Property**

Note. Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.

Keep for Your Records

1.	Enter the total of all payments received or treated as received before repossession	**$9,000**
2.	Enter the total gain already reported as income	**$1,800**
3.	Subtract line 2 from line 1. This is your gain on the repossession	**$7,200**
4.	Enter your gross profit on the original sale	**$5,000**
5.	Enter your costs of repossessing the property	**$500**
6.	Add line 2 and line 5	**$2,300**
7.	Subtract line 6 from line 4	**$2,700**
8.	Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession	**$2,700**

Basis. The taxpayer's basis in the repossessed property is determined as of the date of repossession. It is the sum of the following amounts.

- The taxpayer's adjusted basis in the installment obligation
- Repossession costs
- Taxable gain on the repossession

To calculate the adjusted basis in the installment obligation at the time of repossession, multiply the unpaid balance by the gross profit percentage. This amount is subtracted from the unpaid balance.

The following worksheet from IRS Pub. 537 can be used to determine the basis of real property repossessed.

Worksheet E. **Basis of Repossessed Real Property**

Keep for Your Records

Note. Use this worksheet to determine your basis in the repossessed real property.

1.	Enter the unpaid balance on the installment obligation	
2.	Enter your gross profit percentage for the installment sale	
3.	Multiply line 1 by line 2. This is your unrealized profit	
4.	Subtract line 3 from line 1. This is your adjusted basis in the installment obligation on the date of the repossession	
5.	Enter your taxable gain on the repossession	
6.	Enter your costs of repossessing the property	
7.	Add lines 4, 5, and 6. This is your basis in the repossessed real property	

Scenario 31. Use the same facts as in **Scenario 30.** The unpaid balance of the installment obligation (the $20,000 note) is $16,000 at the time of repossession because the buyer made a $4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, $3,200 (20% × $16,000 still due on the note) is unrealized profit. Linn calculates his basis in the repossessed property as follows using the worksheet from IRS Pub. 537.

Worksheet E. **Basis of Repossessed Real Property** *Keep for Your Records*

Note. Use this worksheet to determine your basis in the repossessed real property.

1.	Enter the unpaid balance on the installment obligation	**$16,000**
2.	Enter your gross profit percentage for the installment sale	**20%**
3.	Multiply line 1 by line 2. This is your unrealized profit	**$3,200**
4.	Subtract line 3 from line 1. This is your adjusted basis in the installment obligation on the date of the repossession	**$12,800**
5.	Enter your taxable gain on the repossession	**$2,700**
6.	Enter your costs of repossessing the property	**$500**
7.	Add lines 4, 5, and 6. This is your basis in the repossessed real property	**$16,000**

Holding Period for Resales. If the taxpayer resells the repossessed property, the resale may result in a capital gain or loss. To determine whether the gain or loss is long-term or short-term, **the taxpayer's holding period includes the period they owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.**

If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad Debt. If the taxpayer repossesses real property under these rules, they cannot take a bad debt deduction for any part of the buyer's installment obligation. This is true even if the obligation is not fully satisfied by the repossession.

If the taxpayer took a bad debt deduction before the tax year of repossession, they are considered to have recovered the bad debt when they repossess the property. The taxpayer must report the bad debt deduction taken in the earlier year as income in the year of repossession. However, if any part of the earlier deduction did not reduce their tax, they do not have to report that part as income. The taxpayer's adjusted basis in the installment obligation is increased by the amount they report as income from recovering the bad debt.