

# The Basics of Tax Basis

You probably know that when a capital asset is sold for profit, it is subject to a capital gains tax. But, did you know that *how you acquired* the property and *what you have done with it* since its acquisition will affect the determination of basis and, ultimately, the gain on which the tax is paid?

Basis is used to determine gain upon the disposition of an asset. In simple terms, basis is an owner's out-of-pocket cost for the asset. For purchased property, the starting basis is the *original* price paid (plus any acquisition costs). An asset's basis can be *increased* (e.g., by making improvements to real property) or *decreased* (e.g., after a casualty loss reduces the value of an asset) and can change according to how it was acquired and the nature of the eventual disposition. Adjusted basis refers to changes in basis after an asset was acquired.

Here's a closer look at basis and how it can affect capital gains:

## Selling an Asset

Assume that Patti (a hypothetical case) bought an antique rug for \$25,000. While having the antique appraised, Patti learned its current fair market value (FMV) is \$85,000. Patti's basis is the original cost of \$25,000. If she were to sell the antique rug at current FMV, her taxable gain would be \$60,000 (\$85,000 selling price minus \$25,000 basis).

## “Gifting” an Asset

Now, suppose Patti decides not to sell the rug, but rather to *give* it to her daughter, Gemma. As a general rule, the donee (Gemma) assumes the basis of the donor (Patti) at the time of the gift (plus a portion of any gift tax incurred by the transfer). However, if Gemma were to sell the antique rug, *her* gain or loss on the sale would depend upon whether the FMV of the antique at the *time of the gift* was greater, or less, than its adjusted basis at that time.

If the FMV at the time of the gift is greater than the donor's (Patti's) basis of \$25,000, then Patti's basis is used to determine the gain or loss. However, suppose the FMV at the time of the gift is *less* than Patti's basis—say \$15,000. In that case, the foundation for determining a gain and loss are different. For a loss, the donee's (Gemma's) basis is the lesser of the donor's (Patti's) cost of \$25,000 or the

FMV at the time of the gift, which is \$15,000. For a gain, assuming the antique is still valued at \$85,000 when Gemma sells it, the basis remains Patti's basis of \$25,000.

## Bequeathing an Asset

After reviewing these rules with her tax advisor and being apprised of possible gift tax consequences for any gift exceeding \$14,000 per person per year (for the year 2013), Patti wonders if other techniques exist to transfer the antique rug to Gemma with fewer tax complications.

Upon further investigation, Patti learns that the basis of property acquired by inheritance is adjusted to the FMV of the property at the time of the owner's death. Thus, if she were to *bequeath* the antique to Gemma, Gemma's basis in the antique would be the FMV of the antique on the date of Patti's death.

Therefore, the main advantage of acquiring property through inheritance is that it allows the recipient to sell the property shortly after inheriting the property with little or no capital gains tax. Assuming that an immediate sale of an inherited asset would be at the asset's FMV, there would be *no recognized gain* since the basis (FMV) would also be the same. Even if the asset was held for some time after inheritance, an eventual sale would result in a smaller capital gains tax, due to the higher (stepped-up) basis established at inheritance.

Capital gains tax laws can be complicated. Understanding how basis is determined can help you make wise choices about disposing of your capital assets. This knowledge can help you minimize the tax burden for yourself, your heirs, and those to whom you give gifts.

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