

## Basis\*

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### Introduction

Basis is a short version of the term ‘Adjusted Tax Basis.’ Basis measures an owner’s investment in an asset. Usually basis decreases each year by the amount of depreciation taken on the asset. When it comes time to sell an asset, basis is just about the only thing that can lower the tax bill. Gains (which are taxable) are figured using basis, so keeping track of the adjusted tax basis of assets is important. This is how basis is used to figure a gain:

$$\text{Sales Price} - \text{Basis} = \text{Gain.}$$

### What is the Basis of an Asset?

The starting basis of an asset depends on how you get that asset.

#### Assets you buy

For an asset that you buy, your basis is what you paid for it, or the purchase price. (You may add sales tax, freight, legal fees, and recording fees to the purchase price.) For example: a tractor purchased for \$40,000 outright has a basis of \$40,000.

#### Assets you trade for

Assets that you buy with a trade-in item generally have a basis of the ‘boot price’ (the cash you pay) unless there is a basis remaining in the traded item.

- If there is basis left in the traded item, then the basis in the traded item is added to the boot price.

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**Example 1:** If you buy a tractor for \$40,000 but trade a tractor in for \$15,000 (with a basis of zero) you have a basis of \$25,000 in the new tractor, as you actually wrote the check for that amount. We often call that the ‘boot price’.

- If the asset you trade has a basis above zero, then that amount generally is added to the basis of the asset purchased.

**Example 2:** If the tractor above is traded in for \$15,000 and has a basis of \$20,000 then the basis in the new tractor is \$45,000.

Price of new tractor	\$ 40,000
Value of trade in	<u>- 15,000</u>
Boot paid	\$25,000
Basis of trade-in	<u>+ 20,000</u>
Basis of new tractor	\$45,000

The \$40,000 cost of the tractor is the amount you pay in cash, plus any new debt for the tractor, other property given in trade, or services that you provide to cover some of the purchase price.

## Assets given to you

For a business asset that you receive as a gift, you need to know what the basis was from the person that gave it to you. When, and if, you sell the asset, your basis may be the donor’s basis, or the fair market value on the date of the gift. Note that the words ‘may’ and ‘or’ are used here. There are specific rules that must be followed. Check IRS Publication 225, ‘Farmer’s Tax Guide, or IRS publication 551 ‘Basis’ for specific rules.

## Assets you inherit

For an asset that you inherit, your basis is usually the fair market value of the asset on the date of death. This is called a ‘step up in basis.’ (For deaths that occurred in 2010, special rules apply, please see IRS Publication 4895.)

## Basis

There are four different ways to acquire an asset, and four different ways to begin the tax basis of the asset. Basis reflects your investment in a property.

Think about a tractor that is worth \$ 25,000. If you pay that amount to buy it, your basis starts at \$25,000. If an uncle gives it to you, you need to ask what his basis was in the tractor. If the uncle dies, and you inherit the tractor, your basis starts as the fair market value of the tractor on the date of his death.

Knowing your basis and tracking it over time can be a challenge. Especially for assets that were given to you or assets that you inherit.

## **Increases to Basis**

The tax basis of an asset increases if we make an improvement to the asset and we cannot depreciate that improvement. That happens for land, but not many other business assets.

For a piece of machinery, like a tractor, we may make an improvement to the tractor; say a 'motor job.' Usually we will depreciate the 'motor job,' and while that capital investment will increase the value of the tractor we will depreciate the 'motor job' separately from the tractor.

In a private home, which is not depreciable, improvements that we make are added to our basis: things like a new roof, new furnace, new windows, or rewiring. Repairs are not depreciable and thus do not affect basis.

## **Decreases to Basis**

The most common way to decrease the tax basis of an asset is by depreciation. Depreciation represents the wearing out or using up of an asset little by little each year. So, the basis of an asset (like a piece of machinery, or breeding livestock, or a building) decreases each year until it reaches zero, is sold or traded, or, in the case of livestock, dies. If a taxpayer uses the Section 179 Expense Deduction (only certain items qualify) or the 'Special depreciation allowance' (again only certain items qualify), the amount used on an asset decreases the basis in that asset, just like depreciation.

## **Other Situations**

Land does not depreciate. Investments in your land may increase the basis of land while you own it. Things that may increase your basis include: bringing electricity in, legal fees involving the title, or clearing or grading the land.

A house (that you live in) is another asset that does not depreciate. The home that you own and live in has a basis, and you may add to the basis over time. But we cannot depreciate our primary residence.

When people own a farm together, such as a partnership, LLC, or corporation, the basis gets more complex.

- Each owner has a basis in the business. Usually this is how much they have invested in the business. Their basis may go up or down depending on new capital contributions to the business, distributions from the business, and retained profits or losses. It can be a real challenge to track the owners' basis in the business over time. This is a good reason to have an accountant. An owner's basis in a business will impact the individual's share from the dissolution or sale of that business.
- In addition, the business itself probably owns assets, and is depreciating them. If so, the basis of these assets needs to be tracked.

## Conclusion

'Basis is the amount of your investment in property for tax purposes,' IRS tells us. When we first get an asset, it has a basis. Then, while we own it, we usually adjust that basis down each year by the amount of depreciation that we take. Somebody has to track the basis of each asset annually, either owners or accountants. People used to use depreciation books for tracking, and now generally use computer programs. The adjusted tax basis for each asset has to be recorded for later use. Basis comes into the calculation of gain when an asset is sold.

## IRS Publications

To access IRS forms and publications, go to [www.irs.gov](http://www.irs.gov) and click on "Forms and Publications". Then click on "Publication number" under "Download forms and publications by:" Type the publication number in the find box to search for the publication. Publications may be viewed online or downloaded by double clicking on the publication.

You can learn more about tax basis by reading *The Farmer's Tax Guide, IRS Publication 225, Chapter 5, Basis*; or by reading *IRS Publication 551, Basis of Assets*.

## Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see [RuralTax.org](http://RuralTax.org).

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