II. CALCULATION RULES

The basic formula in determining the gain or loss is as follows:

Amount Realized
< Adjusted Basis of Asset Sold >
Gain
OR
Loss

A. Amount Realized

Amount Realized
< Adjusted Basis of Asset Sold >
Gain
OR
Loss

The amount realized includes:

1. Cash received (boot);
2. Cancellation of debt (boot);
3. Property received at fair market value; and
4. Services received at fair market value;
5. Reduce the amount realized by any selling expenses (e.g., broker's commissions).

EXAMPLE
Taxpayer conveys commercial property in which he has a basis of $70,000 and which is subject to a mortgage of $45,000 to X for $60,000 in cash. The taxpayer is treated as if he had received $105,000 ($45,000 + $60,000) in the transaction, whether or not X expressly assumes the mortgage, and the taxpayer realizes a gain of $35,000 ($105,000 proceeds minus $70,000 basis).

B. Adjusted Basis of Asset Sold

1. Purchased Property Basis = Cost

Amount Realized
< Adjusted Basis of Asset Sold >
Gain
OR
Loss

Generally, the basis of property is the cost of such property to the taxpayer. There are a number of instances in which the taxpayer's basis in property is to be adjusted upward or downward.

a. Increase Basis for Capital Improvements

Basis

Basis is adjusted upward for expenditures chargeable to the asset account.

EXAMPLE
Taxpayer owns a factory and adds on a new wing for $50,000. The basis of the factory is increased by $50,000.

b. Reduce Basis for Accumulated Depreciation *(= NBV)*

The basis is adjusted downward in the amount of any depreciation (allowed or allowable) by the taxpayer with respect to that asset.

EXAMPLE
A taxpayer has a milling machine purchased for $10,000. In its first year, he deducts $1,000 from gross income for depreciation of the machine. The basis of the machine is accordingly reduced to $9,000 ($10,000 minus $1,000 depreciation deduction).

c. "Spreading" Adjustments

Although most adjustments require an increase or decrease in the basis, some spread the basis.

EXAMPLE
Under the IRC, the receipt of a nontaxable stock dividend will require the shareholder to spread the basis of his original share over both the original shares and the new shares received resulting in the same total basis, but a lower basis per share of stock held.

2. Gifted Property Basis for Gain/Loss Purposes

a. General Rule—*Donor's Rollover Cost Basis*

Property acquired as a gift generally retains the rollover cost basis as it had in the hands of the donor at the time of the gift. Basis is increased by any gift tax paid that is attributable to the net appreciation in the value of the gift. Gains and losses are calculated using this rollover cost basis (subject to the exception noted below).

b. Exception—*Lower FMV at Date of Gift*

If the fair market value at date of gift is lower than the rollover cost basis from the donor, the basis for the donee depends upon the donee's future selling price of the asset.

(1) Sale of Gifts at Price Greater than Donor's Rollover Basis *(gain basis)*

When a taxpayer sells a gift for greater than the rollover basis, the gain shall be the difference between the sale price and that rollover basis.

EXAMPLE
Donor gives nondepreciable property worth $3,000 and having an adjusted basis of $5,000 to taxpayer, who subsequently sells the property for $6,500. The taxpayer's gain will be $1,500 ($6,500 proceeds minus $5,000 basis).

(2) Sale of Gift at Price Less than Lower Fair Market Value *(loss basis)*

When a taxpayer sells the gift for less than the lower FMV at the date of gift, the basis of the gift for purposes of determining the loss is the fair market value of the gift at the time the gift was given.

EXAMPLE
Donor gives property worth $3,000 having an adjusted basis of $5,000 to taxpayer who subsequently sells the property for $1,000. The taxpayer's loss will be $2,000 ($3,000 FMV at date of gift minus $1,000). (Note that the loss may or may not be deductible on the taxpayer's income tax return, depending on the situation.)

(3) Sale Less than Rollover Cost Basis but Greater than Lower Fair Market Value *(in the middle)*

When a taxpayer sells a gift for a price less than the donor's rollover cost basis, but more than the lower fair market value at the date of gift, neither gain nor loss is recognized. The basis to the donee is the "middle" selling price.

c. Gifted Property Depreciation Calculation

Regardless of the basis for the gain/loss (which may not be known at the time depreciation is to begin), the basis for depreciation purposes (if applicable) is the lesser of (i) the donor's adjusted basis at the date of gift or (ii) the fair market value at the date of gift. The amount of accumulated depreciation will then reduce the taxpayer's basis calculated for gain/loss purposes (per above) before the actual gain or loss on the sale is determined.

EXAMPLE

A donor gives property worth $3,000 and having an adjusted basis of $5,000 to a taxpayer.

- For purposes of determining gain on the sale, the taxpayer's basis is $5,000.
- For purposes of determining loss on the sale, the taxpayer's basis is $3,000.
- If the taxpayer subsequently sells the property for $3,500, there is no gain or loss on the sale, and the basis is $3,500
- For purposes of calculating depreciation on the asset (if applicable) prior to the sale, the depreciable basis is $3,000.

PASS KEY

- Sell higher ⟶ Use "donor's basis" to determine gain.

Donor Basis

- Sell between ⟶ No gain or loss

Lower FMV at Date of Gift

- Sell lower ⟶ Use "lower FMV at date of gift" to determine loss.

d. Holding Period

The recipient of the gift normally assumes the donor's holding period. However, under the exception above, if fair market value at the time of gift is used (loss basis) as the basis of the gift, the holding period starts as of the date of the gift (see situation 3 below).

EXAMPLE

BASIS OF GIFTED STOCK AND GAIN OR LOSS ON RESALE

	General Rule: FMV Higher	Exception: FMV Lower		
	1	2	3	4
Donor's (rich uncle) basis	$20,000	$20,000	$20,000	$20,000
FMV at gift date	40,000	13,000	13,000	13,000
Nephew's selling price	30,000	25,000	10,000	15,000
"Basis" to nephew for gain/loss purposes	20,000	20,000	13,000	15,000
Taxable gain (if any)	10,000	5,000		-0-
Deductible loss (if any)			3,000	-0-

3. Inherited Property Basis

a. General Rule—*Date of Death FMV Becomes Basis*

Property acquired by bequest or inheritance generally takes as its basis the step-up (or step-down) to the fair market value at the date of the decedent's death.

b. Alternate Valuation Date

If validly elected by the executor, the fair market value on the alternate valuation date (the earlier of 6 months later or the date of distribution/sale) may be used to value all of the estate property. The alternate valuation date is only available if its use lowers the entire gross estate and estate tax (although individual assets may go up or down during the period). [Note: Estate taxation is covered in detail in Lecture R4.]

If the alternate valuation date is validly elected, the asset is valued using FMV at the earlier of:

(1) Distribution date of asset; or

(2) Alternate valuation date (earlier of 6 months after death or date of distribution/sale).

EXAMPLE
Testator died owning property worth $60,000 and in which he had a basis of $20,000. His son inherited the land and subsequently sold it for $55,000. The son will recognize a loss of $5,000 ($60,000 basis minus $55,000 proceeds). The gain inherent in the property at the time of the testator's death goes unrecognized.

c. Holding Period

Property acquired from a decedent is automatically considered to be long-term property regardless of how long it actually has been held.

EXAMPLE BASIS OF INHERITED PROPERTY (years after 2010)

1. Assume a taxpayer inherited property from a decedent. The FMV at date of death was $20,000. The property was worth $15,000 six months later, and was worth $22,000 when it was distributed to the taxpayer eight months later. It had a cost basis to the deceased of $5,000.

   What is the basis of inherited property to the taxpayer:

a. If the alternate valuation date was not elected?	$20,000
b. If the alternate valuation date was elected?	$15,000

2. Assuming the beneficiary sold that property for $25,000, compute the capital gain:

a. Assuming the alternate valuation date was not elected.	$5,000 = 25,000 – 20,000
b. Assuming the alternate valuation date was elected.	$10,000 = 25,000 – 15,000

PASS KEY

REALIZED*, BUT NOT RECOGNIZED, GAINS OR LOSSES

AMOUNT REALIZED	Money Received (boot) C.O.D. (boot) FMV Property Less: Selling Expenses
< ADJUSTED BASIS OF ASSET SOLD >	Purchase = Cost Gift = Rollover Cost Inherited = Step-up FMV
GAIN	**H**omeowners Exclusion **I**nvoluntary Conversion **D**ivorce Property Settlement **E**xchange of Like Kind (Business) **I**nstallment Sale **T**reasury Capital & Stock
OR	
LOSS	**W**ash Sale Losses **R**elated Party Losses **A**nd **P**ersonal Losses

* All realized gains and losses are recognized (i.e., reported on the tax return) unless "HIDE IT" or "WRaP" applies.