

# Golden Bullets

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## INCOME TAX BASIS:

### THINGS TO CONSIDER

When assets are sold, gain or loss on the transaction is usually recognized for federal income tax purposes. Gain is measured by comparing the net proceeds received against *income tax basis*, sometimes also called *cost basis*.

What is cost basis, how is it calculated and when is it important?

The IRS says that *cost basis is the amount of investment in property* or security for tax purposes. It is used to figure gain or loss on the sale or other disposition of property. It is also used to figure depreciation, amortization, and casualty losses.

Cost basis can be an especially important number for the *owner of a closely held business*. For example, if the business is organized as an S corporation or partnership, the owner's cost basis may allow certain distributions to be tax free. Further, if the owner of a business sells to family or a third party, cost basis will dictate how much of the sales proceeds are subject to capital gains tax.

The concept of basis is even more important in the estate planning context. In the past, family members inheriting property received a *step-up in basis* on those assets. If the person inheriting the asset sold the property the next day, there would be *no capital gains tax* to pay.

In calendar year 2010, the traditional *step-up in basis rule has been replaced* with a limited step-up rule, accompanied by *carryover basis rules* for remaining assets. That means that those who inherit property this year may have to worry more about their prospective income tax liability when the asset is sold.

Calculation of basis starts with figuring out how much has been spent to purchase an asset.

**Capital improvements**, such as adding a room to a rental home, increase the asset's basis. Further, government or association assessments for improvements, such as for sidewalks or roads, also increase the basis for real estate.

In **pass-through businesses**, such as S corporations, partnerships or proprietorships, undistributed business profit will also increase the owners' basis in the business.

**Cost basis is often decreased** by certain activities that improve today's net cash flow. For example, *depreciation deductions* diminish real property's basis. Here are some other items that might reduce a taxpayer's cost basis in the underlying asset:

- Claiming a Section 179 deduction for the asset
- Receiving nontaxable corporate dividends
- Claiming casualty or theft losses
- Receiving rebates
- Taking certain tax credits, such as for qualified vehicles

Basis affects the economics of the sale of certain assets, and the taxation of distributions associated with others. If you have questions about how to calculate cost basis—or how cost basis might affect your financial decisions—feel welcome to get in touch with me.

***AS ALWAYS, PLEASE FEEL FREE TO CALL TO DISCUSS THESE OR OTHER FINANCIAL SECURITY ISSUES OF CONCERN.***

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