Tax Tips You Can Use

‘BASIS’ -Understanding the tax term and examples
By Kathleen Crawford, EA LTC #27851-C
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Many people are baffled by the tax term ‘basis’. The basis of a property is important because it is only the ‘gain’ or difference between the sales price and the basis that is subject to tax. Tax law defines basis as ‘the measure of a person’s investment in a property”. That sounds simple, but as in many things, the reality is not simple.

In this article there are several simplified examples. The examples are used to illustrate the factors involved. It is important to be knowledgeable or have an expert calculate the basis of property to make sure that the proper amount of gain is calculated. Many people underestimate their basis and pay more tax than required because they overlook valid items of basis.

In the simplest example, a taxpayer buys stock and writes a check for $120. A few days later the stock is sold and the taxpayer receives a check for $150. The basis of the stock is $120 and a gain of $30 is taxable. The broker fee to buy the stock is included in basis. In most cases, that fee is calculated into the price of the buy transaction. The stock purchased in this example cost $1 per share for 100 shares and had a $20 transaction fee added, thus the total investment or basis was $120.

Buying land as an investment is a more complicated basis calculation. A lot was purchased in 2004 for $10,000. Title costs of $800 were paid in escrow. Property taxes of $500 per year were paid in 2004 and in 2005. The land is sold in 2006 for $11000. Is there a taxable profit on this transaction? The answer is yes, there is a taxable profit of $200. The basis of the property is $10800, which includes the original $10,000 purchase and $800 in title costs. The $1000 of property tax is not added to basis. Property taxes are deductible in the year paid. In general, if you can claim a deduction for a payment, then is not added to the basis of the property.

The most complicated basis calculation that many taxpayers face is the basis of their home. A family will buy a home, keep it for 20 years, fixing and improving as they go along and then sell it at a great profit. There is an exclusion for the gain on the sale of a personal residence which is limited to $250,000 per taxpayer. That may seem like a lot of money, but many people who keep their home for decades pay capital gains even after the exclusion. It is critical to track your basis in your home. That can be difficult for two reasons. First, if you keep your home for twenty years, you must track your expenses for twenty years. Imagine 20 years of receipts- faded and torn. The second reason that is difficult to track the basis in your home is that some items for your home are added to basis and some are not. Remember that tax law defines basis as the investment in your property. If you spend money to fix your hot water heater, you are not investing in the property, you are merely maintaining it at its current value. If instead, you replace the broken water heater with a new larger, energy efficient, set back model then you are improving the quality of the home and therefore investing in your home. The new hot water heater expense would add to basis. In general, repairs are not added to basis, but improvements are added.

Basis calculations must be made on pensions with employee contributions, investment property, any property that has been depreciated, stocks, bonds, mutual funds and IRA's with nondeductible contributions. Some of these calculations can take hours of expert research to calculate correctly.

There is good news and bad news about the basis of most of our IRA's and 401(k)'s. The good news is that the basis is easy to calculate. The bad news is that the basis is zero because we deducted the amounts invested from our taxable income.

The Jacksonville Tax Lady LLC (OR License #13695) is located in beautiful, historic Jacksonville at 610 N. Fifth Street across from the Pony Espresso. Kathleen and Angela can be reached at 541-899-7926.

The fine print: This article is for information only. Please see your tax professional for questions about your individual tax situation.

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