

The Basics of Tax Basis

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Introduction

Basis is a term used to describe the initial investment made in an asset, typically a capital asset. Over time, the basis can increase or decrease, depending on the circumstances and asset type. The basis of a depreciable asset will decrease over time by the allowable tax depreciation taken. The basis can increase when improvements are made that increase the useful life of the asset. The change in the original (unadjusted) basis due to depreciation, improvements, or for other reasons, becomes the adjusted tax basis. The adjusted basis is the total measurement of an owner's investment in that asset when the time comes to divest the asset through sale, trade, gift, or other means. The adjusted tax basis is used to determine the tax liability associated with the disposition of the asset. The resulting gain or loss calculation requires good records tracking the changes to basis over time. If the basis is not recorded and tracked accurately then the owner may be unable to substantiate the adjusted tax basis of the asset, in which case the IRS will then assume that the adjusted tax basis is "\$0". This will likely increase the tax liability associated with the disposition. To determine the taxable gain or loss, the following equation is used:

$$\text{Sales Price} - \text{Adjusted Tax Basis} = \text{Gain or Loss}$$

If the sale results in a gain, an additional calculation will be needed to determine the amount of the gain that will be taxed as short-term and or long-term capital gain.

Basis

Since there are multiple ways to acquire an asset, the way to determine the beginning tax basis of the asset may be different, based on the method of acquisition. The unadjusted basis simply reflects the initial investment in a property. The adjusted tax basis reflects the initial investment minus (-) tax depreciation plus (+) any additional investment in the asset.

Knowing the adjusted tax basis of the asset and tracking it over time can be a challenge. To help with the tracking of the basis, the assets basis should be recorded in multiple places. Documents and locations to be recorded include the original acquisition documents, accounting records that

capture the initial purchase, the tax depreciation schedule that should track the adjusted tax basis over time, and an annual balance sheet that may track the cost basis, economic depreciation, the market, and/or the book value of the asset(s).

Increases to Basis

The tax basis of an asset may increase if an improvement is made to the asset that gets capitalized as part of an adjusted tax basis. There may be some possible improvements that, in rare circumstances, may not be able to be depreciated. Please seek out a tax professional to make the determination surrounding a specific situation.

An improvement to a tractor, such as a new engine, will increase the value of the tractor and is considered a capital investment. The engine will be recorded, tracked, and depreciated separately from the tractor.

A home used for personal use that is not used, in whole or in part, in a trade or business is not eligible for tax depreciation. A tax basis still exists for personal purposes, and any changes to basis should be tracked. The value of any eligible improvements are added to the tax basis of the house. This may include improvements such as a new roof, furnace, windows, or electrical rewiring and similar.

Decreases to Basis

The most common reason a tax basis may decrease is through tax depreciation. Depreciation represents the wearing out or "use" of an asset over time. Economic depreciation may occur which does not affect tax basis, but does affect the Fair Market Value (FMV). This is most often seen in vehicles, machinery, and equipment. Most new vehicles will lose between 30% and 50% of their market value in the first five years. Tax depreciation will allow the owner of an asset used in a trade or business to decrease the tax basis in the asset over the expected tax life of the asset. The tax life is determined by the IRS, and places assets in to one of multiple classes established by the IRS, using Modified Accelerated Cost Recovery System (MACRS). Regardless of the depreciation method used for tax purposes, any depreciation taken will decrease the tax basis of the asset. The tax basis of an asset will be adjusted downward over time until it either reaches zero, is sold, traded, junked, scrapped, or, in the case of livestock, dies. If a taxpayer uses the Section 179 Expense Deduction (only certain assets qualify) or the Section 168 Special Allowance, usually referred to as 'bonus' depreciation (only certain assets qualify), the

amount of depreciation of the asset decreases the basis of the asset in a more rapid manner.

Acquired Assets, Determining the Basis

The beginning basis of an asset is dependent on how the asset is acquired. Assets can typically be acquired in one of three ways. 1) purchase, 2) gift, or 3) inherited through an estate. Each of these acquisition types requires a different method to determine the basis of the acquired asset.

Purchased Assets

The unadjusted basis of a purchased asset is the entire cost of acquiring the asset. Some costs to acquire an asset may include, but are not limited to, the purchase price, sales tax, freight, legal fees, recording and document fees, etc. For example, a tractor purchased at a selling price of \$38,000 for the tractor, plus \$1,250 sales tax and \$750 of fees, equates to an unadjusted basis of \$40,000.

Assets That Are Traded and/or Sold

The Tax Cuts and Jobs Act (December 2017) changed how basis was determined when acquiring assets that include a trade-in. The adjusted tax basis of the traded-in asset is no longer used to determine the unadjusted basis of the newly acquired asset.

The traded asset is treated as a sale, as if cash was received for the asset. The newly acquired asset will have an unadjusted basis that is equivalent to the fair market value (FMV) of the asset, as determined by the seller as the sales price before the value of the trade is considered.

Example 1: Asset traded with an adjusted basis of \$0

In 2010, a tractor was purchased for \$80,000. The tractor has been fully depreciated leaving an adjusted tax basis of \$0. In 2025, a replacement tractor is purchased that is valued at \$100,000. The 2010 tractor is traded-in and has a trade-in value of \$15,000 (with an adjusted tax basis of zero). Depreciation recapture will be owed on \$15,000, and the unadjusted tax basis in the new tractor purchased in 2025 will be \$100,000. This is true even though the actual cash exchanged is \$85,000 (value of tractor being purchased of \$100,000 minus the trade-in value of \$15,000). The \$85,000 is referred to as the “cash to boot”.

Occasionally, an asset may be sold or traded at a price higher than when it was acquired. If the asset was depreciated, the disposition of the asset may trigger depreciation recapture and a capital gain (short- or long-term, dependent on the length of time the asset is held).

Example 2: Asset sold/traded at a higher price than purchased

In 2023, an implement is purchased for \$20,000. The implement is depreciated out using Section 179 to expense the full value, deducted in 2023 through depreciation. The implement is used for two seasons, and is sold in 2025 for a total of \$28,000, with an adjusted tax basis of \$0.

2023 Purchase Price	\$20,000
2023 Section 179	-20,000
Adjusted Tax Basis	\$0
2025 Sold	\$28,000
Depreciation Recapture on:	\$20,000
Long-Term Capital Gain on:	\$8,000

Since the sale price in 2025 is \$8,000 above the original purchase price, and the asset was depreciated to \$0, Depreciation Recapture would be owed on the original unadjusted basis of \$20,000. The \$28,000 selling price minus the unadjusted basis leaves \$8,000, and since the asset was held for more than a year, long-term capital gain is owed on the \$8,000.

Gifted Assets

For any asset received as a gift, the receiver of the gift should request all documentation that can prove the asset's adjusted tax basis. The carryover basis and the holding period that the donor (the person giving the gift) had in the asset will now become the recipient's adjusted tax basis and holding period. There are special rules that must be followed concerning property received as a gift. Review [IRS Publication 225, The Farmer's Tax Guide](#), or [IRS Publication 551, Basis of Assets](#), for the specific rules.

Inherited Assets

For any asset received as a gift, the receiver of the gift should request all documentation that can prove the asset's adjusted tax basis. The carryover basis and the holding period that the donor (the person giving the gift) had in the asset will now become the recipient's adjusted tax basis and holding period. There are special rules that must be followed concerning property received as a gift. Review [IRS Publication 225, *The Farmer's Tax Guide*](#), or [IRS Publication 551, *Basis of Assets*](#), for the specific rules.

Other Situations

Land is one of the few assets that does not have a depreciable tax life. Investments in the land may increase its tax basis. Things that may increase the basis can include: adding electrical service, legal fees involving the acquisition of the property, and the clearing or grading of the land.

A house (that you live in) is another asset that does not have a depreciable tax life. The home that is owned and lived in does still have a tax basis that will become important if the house is ever sold. Over time, improvements may be added that may increase the basis while, in some cases the basis may decrease. If the home is personally owned and is the primary residence, the value of the home cannot be depreciated for tax purposes.

When people own a farm together through various entities, such as a partnership, LLC, or some corporation types, the basis can become more complex.

- Each owner has a basis in the business. The basis is how much the owner has invested in the business. The basis may increase or decrease, dependent on any capital contributions made to the business, distributions made to the owner(s), any debt held by the business, and any retained profits or losses held by the business entity. It is a challenge to track the owners' basis in a business over time. Tracking the basis of the property usually requires a good tax or legal professional to track and record. An owner's basis in a business will impact the value of the individual's share from the dissolution or sale of the business interest.
- In addition, the business itself may own assets that are, or have been, depreciated. If so, the basis of these assets need to be recorded. Dependent on the business structure, the tax depreciation may be

passed through to the individual partner(s)/owner(s)/member(s).

Conclusion

The tax basis is the amount of investment that has been made in an asset upon initial acquisition of the asset. Throughout the ownership period of the asset, the tax basis may increase or decrease based on tax depreciation, additional investment, improvements, etc. The summation of the basis changes creates an "adjusted basis". The basis of each asset must be recorded and tracked through accounting records, depreciation schedules, balance sheets, and/or other financial documents. The adjusted tax basis for each asset must be recorded for future purposes, such as asset disposition. The basis must be known at the time of sale, trade, etc., to determine if, and the amount of, any depreciation recapture and/or any taxable gain that may be owed. If the owner of the asset is unable to show appropriate proof through maintained records of the basis, the IRS may determine that the basis of the asset is \$0, potentially increasing the depreciation recapture or gain owed.

IRS Publications

IRS forms and publications can be found by going to www.irs.gov and typing in the name of the publication/form or the publication/form number in the search bar toward the top of the webpage. Publications may be viewed online or downloaded.

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.

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