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## Tax Filing Reminders

**June 17** – The second installment of 2019 individual estimated tax is due.

## What to Do If You Receive a Dreaded IRS Letter

Now that most tax refunds are deposited directly into taxpayers' bank accounts, the dream of opening your mailbox and finding an IRS refund is all but gone. However, the IRS still sends letters that can increase taxpayers' heart rates; because of extensive computer matching, the IRS does most of its auditing through correspondence.

When the IRS detects a potential issue with your tax return, it will contact you via U.S. mail. Please note that the IRS's *first contact about a tax delinquency or discrepancy will never be a phone call or email*. Such calls and emails are a common tool for scammers; if you get one, simply hang up the phone or delete the email. If you are concerned about the validity of a given message, please call this office.

Most commonly, the first notice describes the proposed tax due, as well as any interest or penalties. The notice will also usually explain the examination process and describe how you can respond.

These automated notices can be sent out year-round. As the IRS tries to close the tax revenue gap, it has become more aggressive in its collection efforts and are using these notices more frequently

The first step in this automated process involves matching what you reported on your tax return to the data that third parties (e.g., employers, banks, and brokers) reported. When this information does not agree, the automated collection effort begins.

**Don't Panic** – These notices often include errors. However, you do need to respond before the 30-day deadline or else face significant repercussions. The notice may even be related to suspected ID theft. For instance, someone may have gained access to your tax ID (or that of your spouse or one of your dependents) and tried to file a return using the stolen ID.

Some IRS letters include a proposed—almost always unfavorable—change to your tax return, and it gives you the opportunity to dispute the proposed change. Procrastinating or ignoring this notice will only cause the IRS to ratchet up its collection efforts, which in turn will make it more difficult for you to dispute the proposed adjustment.

Sometimes, the IRS will be correct. You may have overlooked a capital gain or income from a second job. It is also possible that the IRS has caught someone else using your SSN to work or otherwise stealing your identity. Quite frequently, however, the IRS is incorrect, simply because its software isn't sophisticated enough to pick up all the information that you report on the schedules attached to your return.

If you receive an IRS notice, your first step should be to **immediately contact this office** and to provide us with a copy of the notice. We will review the notice to determine whether it is correct, and then we will consult with you to determine how best to respond.

## Why Tax Basis Is So Important

For tax purposes, the term “basis” refers to the original monetary value that is used to measure a gain or loss. For instance, if you purchase shares of a stock for \$1,000, your basis in that stock is \$1,000; if you then sell those shares for \$3,000, the gain is calculated based on the difference between the sales price and the basis:  $\$3,000 - \$1,000 = \$2,000$ . This is a simplified example, of course—under actual circumstances, purchase and sale costs are added to the basis of the stock—but it gives an introduction to the concept of tax basis.

The basis of an asset is very important because it is used to calculate deductions for depreciation, casualties, and depletion, as well as gains or losses on the disposition of that asset.

The basis is not always equal to the original purchase cost. It is determined in a different way for purchases, gifts, and inheritances. In addition, the basis is not a fixed value, as it can increase as a result of improvements or decrease as a result of business depreciation or casualty losses. This article explores how the basis is determined in various circumstances.

**Cost Basis** – The cost basis (or unadjusted basis) is the amount originally paid for an item before any improvements and before any business depreciation, expensing, or adjustments as a result of a casualty loss.

**Adjusted Basis** – The adjusted basis starts with the original cost basis (or gift or inherited basis), then incorporates the following adjustments:

- increases for any improvements (not including repairs),
- reductions for any claimed business depreciation or expensing deductions, and
- reductions for any claimed personal or business casualty-loss deductions.

*Example:* You purchased a home for \$250,000, which is the cost basis. You added a room for \$50,000 and a solar electric system for \$25,000, then replaced the old windows with energy-efficient double-paned windows at a cost of \$36,000. The adjusted basis is thus  $\$250,000 + \$50,000 + \$25,000 + \$36,000 = \$361,000$ . Your payments for repairs and repainting, however, are maintenance expenses; they are not tax deductible and do not add to the basis.

*Example:* As the owner of a welding company, you purchased a portable trailer-mounted welder and generator for \$6,000. After owning it for 3 years, you then decide to sell it and buy a larger one. During this period, you used it in your business and deducted \$3,376 in related depreciation on your tax returns. Thus, the adjusted basis of the welder is  $\$6,000 - \$3,376 = \$2,624$ .

Keeping records regarding improvements is extremely important, but this task is sometimes overlooked, especially for home improvements. Generally, you need to keep the records of all improvements for 3 years (and perhaps longer, depending on your state’s rules) after you have filed the return on which you report the disposition of the asset.

**Gift Basis** – If you receive a gift, you assume the donor’s adjusted basis for that asset; in effect, the donor transfers any taxable gain from the sale of the asset to you.

*Example:* Your mother gives you stock shares that have a market value of \$15,000 at the time of the gift. However, your mother originally purchased the shares for \$5,000. You assume your mother’s basis of \$5,000; if you then immediately sell the shares, your taxable gain is  $\$15,000 - \$5,000 = \$10,000$ .

There is one significant catch: If the fair market value (FMV) of the gift is less than the

donor's adjusted basis, and if you then sell it for a loss, your basis for determining the loss is the gift's FMV on the date of the gift.

*Example:* Again, say that your mother purchased stock shares for \$5,000. However, this time, the shares were worth \$4,000 when she gave them to you, and you subsequently sold them for \$3,000. In this case, your tax-deductible loss is only \$1,000 (the sales price of \$3,000 minus the \$4,000 FMV on the date of the gift), not \$2,000 (\$3,000 minus your mother's \$5,000 basis).

**Inherited Basis** – Generally, a beneficiary who inherits an asset uses its FMV on the date when the owner died as the tax basis. This is because the tax on the decedent's estate is based on the FMV of the decedent's assets at the time of death. Normally, inherited assets receive a step up (increased) in basis. However, if an asset's FMV is less than the decedent's basis, then the beneficiary's basis is stepped down (reduced). There are exceptions to this, for example, this step up also does not apply to inherited qualified retirement accounts.

*Example:* You inherit your uncle's home after he dies. Your uncle's adjusted basis in the home was \$50,000, but he purchased the home 25 years ago, and its FMV is now \$400,000. Your basis in the home is equal to its FMV: \$400,000.

*Example:* You inherit your uncle's car after he dies. Your uncle's adjusted basis in the car was \$50,000, but he purchased the car 5 years ago, and its FMV is now \$20,000. Your basis in the car is equal to its FMV: \$20,000.

An inherited asset's FMV is very important because it is used when determining the gain or loss after the sale of that asset. If an estate's executor is unable to provide FMV information, the beneficiary should obtain the necessary appraisals. Generally, if you sell an inherited item in an arm's-length transaction within a short time, the sales price can be used as the FMV. A simple example of not at arm's length is the sale of a home from parents to children. The parents might wish to sell the property to their children at a price below market value, but such a transaction might later be classified by a court as a gift rather than a bona fide sale, which could have tax and other legal consequences.

For vehicles, online valuation tools such as Kelly Blue Book can be used to determine FMV. The value of publicly traded stocks can similarly be determined using Website tools. On the other hand, for real estate and businesses, valuations generally require the use of certified appraisal services.

The foregoing is only a general overview of how basis applies to taxes. If you have any questions, please call this office for help.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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