

What is “Cost Basis” and How is it Calculated?

Cost Basis is an accounting term. Put simply, the cost basis of your rental property is the value used to determine your capital gain, either now or in the future. The difference between your cost basis and the net sale price of your property is your taxable gain.

Your property’s cost basis is not a fixed or static number. It changes over time. This is because three variables will affect your cost basis:

- **Capital Expenditures (aka “CapEx” or Capital Improvements)**

This includes non-deducted expenses like a room addition, new roof or new HVAC system.

- **Additional Equity or Debt in a 1031 Exchange**

If you acquired more real estate than you sold in a 1031 exchange, your cost basis will increase. For example, if you paid off a loan for \$500,000 and reinvested all your equity, but your replacement property included debt of \$700,000, you have increased your cost basis by \$200,000.

- **Depreciation**

Every year, your tax professional will claim a depreciation deduction for your rental property. For residential rental property, the annual deduction is based on your improvements (everything except the land value) divided by 27.5. For commercial property, the denominator is 39. Certain improvements (like HVAC equipment) may be segregated and depreciated on a shorter schedule. These deductions eventually stop after you have owned the property more than 27.5 years (or 39 years), but adding money to your investment may extend the deduction period.

To calculate your current cost basis before a 1031 exchange, your accountant will follow these basic steps:

1. Start with the original purchase price
2. Add the value of any capital expenditures made toward the property
3. Subtract all cumulative annual depreciation deductions

To calculate your current cost basis after a 1031 exchange, your accountant will follow these basic steps:

1. Start with the result of the above steps
2. Add any equity or debt that was added to the exchange
3. Subtract all cumulative annual depreciation deductions since the exchange

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