

Allocation of Cost Between Land and Building

The issue in this case is the allocation of the property's cost between the land and the buildings. All amounts in this article are rounded to make the article easier to read. Mrs. & Mr. Nielsen purchased three parcels of real estate over the years.

In 2003 the Neilsens purchased Parcel One for \$360,000. At the time the property consisted of land and three buildings. The Office of the Assessor assessed the property at a value of \$425,000, of which \$189,000 was attributable to improvements (i.e., buildings) and \$236,000 to land. These amounts show the improvements constitute 44.4% of the total value of the property.

In 2003 the Neilsens purchased Parcel Two for \$750,000. This property consisted of land and four buildings. The Assessor's office valued the improvements at \$305,000 out of a total assessed value of \$795,000, for a building ratio of 38.4%. The bank obtained an appraisal of the property and the improvements came up to 34% of the total value.

In 2012 the Neilsens purchased Parcel Three for \$520,000. This property consisted of land and two buildings. The Assessor's office valued the improvements at \$164,000 out of a total assessed value of \$533,000, for a building ratio of 30.7%.

Their 2012 income tax return is the subject of this particular court case. Their 2012 Schedule E included depreciation deductions for all three rental properties using the straight-line method with a recovery period of 27.5 years. The depreciation deductions were based on the ENTIRE cost of the three properties, as opposed to just the cost of the buildings.

[Editor's note: We find it interesting that IRS decided to request for verification of the original costs of the properties, even though two of them had been purchased over 10 years earlier. This might be a good case to share with those clients who say "I heard I only have to keep my records for three years." Depreciation seems to be the ONLY reason for this audit. How often do we think that depreciation never gets examined?]

Keep in mind this is a TC Summary Opinion and thus is not able to be used as a precedent for a position although it is useful to see IRS thinking on a particular issue.

Sharon M & Steve L Nielsen, TC Summary Opinion 2017-31. This case can be found by going to www.ustaxcourt.gov, clicking on Opinion Search, and entering Nielsen in the "Case Name Keyword" box and find the case from May 2017.

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