KBKG Insight: Tax Court Rejects Taxpayer's Land vs. Building Allocation

On May 8, 2017, the U.S. Tax Court released Summary Opinion 2017-31 to conclude that a county assessor's allocation to land and improvement values were more reliable than the taxpayers proposed values. The tax court noted they could not find any authority that suggests a taxpayer is qualified to allocate the value of property between land and improvements. The case below highlights the importance of substantiating the values used for tax depreciation purposes when land and building is purchased for one price.

KBKG Insight: In many cases, a real estate appraisal is performed for financing purposes but does not include a value for land. In these instances, where the purchase price is significant, it may be sensible to contact the same appraiser to commission a land appraisal. For income tax purposes, every dollar shifted from land value to improvement value yields permanent tax benefits.

Background

For tax capitalization purposes when purchasing real estate, taxpayers are required to separately identify the value of non-depreciable land from the depreciable improvements (such as buildings and site work). If an appraisal was not conducted at the time of purchase, and the taxpayer feels the county assessor's allocation to land value is excessive, taxpayers may consider the following options:

1. **Rely on the county tax assessor's allocation** - The property tax assessor provides a value of land and improvements based on the municipality's guidelines. While this may not reconcile to the acquisition cost, the ratio between the land and improvement values can be applied to the acquisition cost to provide corresponding values for federal income tax purposes.
2. **Commission a full scope land appraisal** – A qualified professional (such as an MAI) following USPAP guidelines will generate a comprehensive analysis considering factors such as sales comparisons, highest & best use, market conditions, replacement cost, and income generated. While this is the most accurate approach, it can be costly and require several weeks to complete.
3. **Limited scope land appraisal** – A real estate professional, who may not follow USPAP guidelines, simply provides an analysis of sales comparisons.
4. **RTD Method (Role The Dice)** – Also known as the "rule of thumb" approach, a taxpayer uses a predetermined allocation (ie. 80%/20% or 70%/30%) for land and improvements. Many CPAs are not comfortable with this approach and it may raise concerns under IRS examination.

KBKG Insight: A higher depreciable basis in the building improvement category coupled with a cost segregation study generates greater accelerated deductions as relative building component values also increase.

In this specific case, Nielsen v. Commissioner, the taxpayer contested the county assessor's data as "extraordinarily inaccurate," but the Tax Court did not agree. While the Tax Court acknowledged a taxpayer is qualified to testify to the value of their entire property, they found no authority suggesting a taxpayer is qualified to allocate the value of property between land and improvements.

Conclusion
When land and buildings are purchased for one price, tax preparers must advise their clients on the pros and cons of using various approaches to allocate the cost for tax depreciation purposes. Relying on a property tax assessment for this information may result in leaving deductions on the table. In situations where the county tax assessor's land value is excessive, considering other options can yield significant permanent tax benefits that can be further enhanced by a cost segregation study.

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