KBKG

SOLUTIONS FOR TAX PROFESSIONALS AND BUSINESSES
TAX CREDITS • INCENTIVES • COST RECOVERY

KBKG TAX INSIGHT:
HOW TO ALLOCATE LAND VS. BUILDING VALUES FOR YOUR INVESTMENT PROPERTY

Authors: Lester Cook, CCSP & Sasha Brenecki

As featured in Accounting Today

Calculating land and building values for tax purposes is a critical step toward maximizing your available tax deductions from depreciation. This is because the law says you can only depreciate items that wear down over time (i.e., the building and not the land). Since most real estate purchase agreements do not assign value to each category, tax professionals must understand what options are available to determine the appropriate allocation to land and building.

KBKG INSIGHT

In many cases, a real estate appraisal is performed for financing purposes but does not include a value for the 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.

Taxpayers are required to separately identify the value of non-depreciable items (i.e., land) from the depreciable building and

KBKG SERVICES

- Research & Development Tax Credit
- Cost Segregation
- Repair vs. Capitalization Review
- Fixed Asset Review
- 45L Credits for Energy Efficient Residential Developments
- 179D Incentive for Energy Efficient Commercial Buildings
- Transfer Pricing
- IC-DISC
- Employee Retention Tax Credits

site improvements. If a full scope appraisal showing the land value was not completed during the purchase process, taxpayers may consider the following options:

1. **Rely on the county tax assessor's allocation:** A taxpayer can review their county tax assessor's property allocation, which usually provides an assessment of land and improvements based on the county's guidelines. This allocation can be found on the most recent property tax bill or on the county assessor's website. The values listed may not match the total acquisition cost, but the proportionate ratio between the land and improvement values can be applied to the final purchase price for income tax purposes.

   Additional insights on IRS approval of this methodology can be found here.

   ## KBKG INSIGHT

   While the property tax allocation method is most commonly used and generally accepted by the IRS, it's not always the best indication of fair market value. Other methods can be considered should the taxpayer think the allocation to land is disproportionately high.

2. **Commission a full-scope land appraisal:** Another option is to commission a full-scope land appraisal. A qualified professional appraiser will generate a comprehensive analysis considering factors such as sales comparisons, highest and best use, market conditions, and income generated following Uniform Standards of Professional Appraisal Practice guidelines. While this option is the most accurate land valuation approach and least likely to be challenged by the IRS, it is also the most costly and can require several weeks to complete the process.

3. **Limited-scope land appraisal:** A limited-scope land appraisal can be completed by a real estate professional who provides an analysis of sales comparisons or other limited metrics. Similar to a broker's opinion of value, this analysis is less detailed and may not follow USPAP guidelines.

4. **Replacement cost method:** This methodology is supported by a 1982 tax court case, Meiers v Commissioner (T.C. Memo 1982-51), where the taxpayer successfully argued against the property tax "assessed value" allocation. In this approach, the taxpayer calculated that the cost to construct a new building (say, $300 per square foot at 2,000 square feet, totaling $600,000) should be allocated to building and the remaining balance of the acquisition should be allocated to land.

   ## KBKG INSIGHT

   Whatever value is used must still be reasonable and in line with market conditions. The tax court in the Meiers case felt the tax assessor's allocation did not show any evidence to "comport with reality" and the taxpayers estimate was "much closer to the mark." This property was acquired in 1977 when real estate values were not inflated to the level we see today. If a property sells for significantly higher than the replacement cost of the building and land value, this strategy is not optimal.

5. **Rule of thumb method:** Some taxpayers use a predetermined percentage (such as 80/20 percent, 70/30 percent, etc.) for improvements and land. Most tax professionals do not advise their clients to utilize this approach and it may raise concerns under IRS examination. This was highlighted when the U.S. Tax Court released Summary Opinion 2017-31 in May 2017, concluding that a county assessor's allocation to land and improvement values was more reliable than the taxpayer's proposed values. The Tax Court noted it could not find any authority that suggests a taxpayer is qualified to allocate the value of property between land and improvements.

KBKG INSIGHT

If a client owns multiple properties similar to the one in question, in the same geographic region with established land values, some taxpayers have successfully utilized an average of the building and land allocation percentages to apply to the newly purchased property.

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 allocating 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.

To find out more, contact a cost segregation specialist.

Authors: Lester Cook, CCSP & Sasha Brenecki

About the Authors

Lester Cook, CCSP – Principal
Midwest
Lester has nearly 20 years of experience in the tax specialty service industry. He is a Principal and leads KBKG's Fixed Asset Review Practice from our Chicago, IL office. Throughout his career, Lester has completed cost segregation analyses on thousands of properties ranging from office space leasehold improvements to multi-billion dollar industrial complexes. » Full Bio

Sasha Brenecki – Manager
Midwest
Based in Chicago, IL, Sasha Brenecki is a manager with KBKG specializing in Cost Segregation and Fixed Asset Services overseeing the Midwest region. She has over 6 years of experience conducting cost segregation studies, section 481a adjustment calculations, and fixed asset reviews. » Full Bio