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Land Allocation and the IRS

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President Biden wants to boost IRS funding to fight tax evasion. With additional funding, the IRS can hire thousands of new agents, replace old computer systems and provide increased resources and new tools with which to audit taxpayers. Land allocation is low-hanging fruit for IRS examination. This article discusses the importance of the land allocation method when purchasing a property. Getting it wrong could result in additional taxes and penalties.

Burden of Proof

When taxpayers purchase property, in most instances, they pay one price to acquire the building and land; there is no breakdown of the cost on the closing documents. The building is depreciable, and the taxpayer can recover the cost through yearly tax deductions of depreciation. The problem is that land is not depreciable. The taxpayer is required to allocate the cost of land, using any reasonable method. If examined by the IRS, the burden of proof is on the taxpayer to prove that the allocation method used was reasonable.

Taxpayers generally prefer to allocate more to building and less to land for larger tax deductions. As a rule of thumb, many taxpayers allocate 80% to building and 20% to land. But 80/20 is a guesstimate, not based on fact, as land values vary depending on many factors, including location. To avoid provoking the IRS, taxpayers must use a reasonable method to allocate land. The IRS states in Publication 527, "You must divide the cost between the land and buildings to figure the basis for depreciation of the buildings. The part of the cost that you allocate to each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time you buy it. If you aren't certain of the fair market values of the land and buildings, you can divide the cost between them based on their assessed value for real estate tax purposes." The IRS provides little other guidance.

Reasonable Methods of Allocation

The most common reasonable methods are assessed value and appraised value.

The assessed value method of allocation requires taxpayers to review their tax assessors' property records, which usually can be found on the property tax bill. Generally, tax assessors undervalue buildings and overvalue land. We typically see 40% allocated to land on property tax bills. Tax assessors are not concerned with the breakdown between land and building as the tax is based on the whole property. They rely on computer models to arrive at determinations, resulting in assessments that can be off the mark and/or out of date. Assessed values usually provide an unfavorable outcome for the taxpayer.

The appraised value method of allocation requires the taxpayer to hire a qualified appraiser to study comparable property sales, market conditions and rebuilding costs. This method is the costliest and will take some time; however, the appraisal will most likely provide a favorable result to the taxpayer and the IRS is less likely to challenge it.

There are other methods that can be applied and may produce a better result. Your tax professional can advise on the best approach to produce the greatest benefit and ensure money is not left on the table.

Documentation

The bottom line is that taxpayers need proof to back up their land allocations, and they need to be documented. We recommend documenting at purchase. Gathering the information after the fact is time-consuming and expensive. We also recommend that the taxpayer reviews the allocation. The 80/20 rule of thumb is simple but not adequate and will cost more in the long run. A good tax advisor will insist that the taxpayer has evidence to support the land allocation before the IRS comes knocking.

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