13 T.C. 851 (1949)

A taxpayer who inherits property subject to a long-term lease under which the lessee constructed a building is entitled to a depreciation deduction based on the fair market value of the building at the time of inheritance, even if the building's useful life extends beyond the lease term.

Summary

The Tax Court addressed whether a taxpayer who inherited an interest in a building constructed by a lessee on leased land could take a depreciation deduction. The building was erected before the decedent's death under a lease extending beyond the building's useful life. The court held that the taxpayer was entitled to a depreciation deduction based on the fair market value of the inherited interest in the building at the time of inheritance. This decision distinguished the situation from cases where the lessor had no investment in the improvements. The court emphasized that inheritance creates a basis for depreciation distinct from the original cost.

Facts

Charles T. Rowan and Ellen Rowan leased property in Dallas, Texas, in 1919 for 66 years and 10 months. The lease required the lessee to construct a building costing at least $100,000, which would become the lessor's property. The lessee constructed the Gulf States Building in 1928. Ellen Rowan conveyed the property to her three children. Mae Lee Blesi, one of the children, died in 1941, and her daughter, Helen Blesi Pearson, inherited her one-third interest. Pearson then claimed depreciation deductions on her income tax returns, which the Commissioner disallowed.

Procedural History

The Commissioner of Internal Revenue disallowed depreciation deductions claimed by Helen Blesi Pearson and her husband, J. Charles Pearson, Jr., leading to deficiencies in their income tax. The Pearsons petitioned the Tax Court, contesting the Commissioner's decision. The Tax Court consolidated the cases and considered the sole issue of the depreciation deduction.

Issue(s)

Whether the petitioner, who inherited an interest in a building constructed by a lessee, is entitled to a depreciation deduction based on the fair market value of the building at the time of inheritance, where the lease extends beyond the building's useful life.

Holding

Yes, because the petitioner inherited the property and therefore has a basis in the

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property equal to its fair market value at the time of inheritance, as dictated by Section 113(a)(5) of the Internal Revenue Code, entitling her to a depreciation deduction.

Court's Reasoning

The court relied on Section 23(l) of the Internal Revenue Code, stating a prerequisite for depreciation is an investment or depreciable interest in the property. The court distinguished this case from those where the lessor had no investment in the improvements. The court cited *Charles Bertram Currier, 7 T.C. 980*, where a life beneficiary in a testamentary trust was allowed a depreciation deduction on a building constructed by a lessee. The court emphasized that inheriting property establishes a basis distinct from the original cost, the basis being the fair market value at the time of the decedent's death. The court noted that, because the lessee was obligated to return the same building, the taxpayer was entitled to depreciation as the building would depreciate over time, even with proper maintenance. The court stated, "Having acquired a basis by the incidence of the estate tax, the gradually disappearing value of a wasting asset can not be replaced except by periodic depreciation adjustments."

Practical Implications

Pearson v. Commissioner clarifies that inheriting property with improvements made by a lessee creates a depreciable interest for the heir, regardless of whether the lease term exceeds the building's useful life. It reinforces that inherited property's basis for depreciation is its fair market value at the time of inheritance, not the original cost of the improvements. This decision affects estate planning and tax strategies for inherited properties subject to long-term leases, allowing beneficiaries to claim depreciation deductions. This case serves as precedent when determining tax liabilities related to inherited properties, especially where leases and improvements complicate the valuation and depreciability of assets. It emphasizes the importance of accurate valuations for estate tax purposes, as those values will directly influence future depreciation deductions for the heirs.

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