73 T. C. 743 (1980)

Component depreciation is not available for existing improvements to used real property acquired for a lump sum; such improvements must be depreciated with the building over its remaining useful life.

Summary

In Fieland v. Commissioner, the taxpayer purchased a building with existing improvements for a lump sum and sought to depreciate the improvements separately over the remaining term of a lease. The Tax Court ruled that such component depreciation was not permissible, requiring the improvements to be depreciated together with the building over its 30-year remaining life. The court also upheld the IRS's allocation of the purchase price between land and building and rejected the taxpayer's attempts to exclude rent as a return of capital or amortize it as a premium lease payment. This case clarifies that component depreciation for existing improvements on used property is generally not allowed absent specific allocation and valuation evidence.

Facts

In December 1968, Louis C. Fieland purchased a property in Nassau County, New York, from Country Capital Corp. for $1,020,440. The property included a building and land, previously improved by Country Capital to accommodate Grumman Aerospace Corp. as a tenant under a 6-year lease. Fieland allocated his purchase price among land, building, and leasehold improvements, intending to depreciate the improvements over the remaining 57. 5 months of the lease. The IRS challenged this allocation and depreciation method, asserting that the improvements should be depreciated with the building over its remaining life.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Fieland's income tax for 1969-1971 due to his depreciation deductions. Fieland petitioned the U. S. Tax Court, which upheld the Commissioner's determinations. The court ruled against Fieland's component depreciation claim, confirmed the IRS's allocation of the purchase price, and rejected additional claims regarding rent treatment and amortization.

Issue(s)

1. Whether component depreciation is available for existing improvements to a used building acquired for a lump sum.
2. Whether the IRS's allocation of the purchase price between land and building is correct.
3. Whether the taxpayer can exclude from income rent payments that reimburse the lessor for the cost of improvements.

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4. Whether the taxpayer can amortize a portion of the purchase price as the cost of acquiring a premium lease.

Holding

1. No, because the taxpayer purchased a unified structure, and there was no separate valuation of the improvements at the time of purchase.
2. Yes, because the taxpayer failed to provide convincing evidence to overcome the IRS's allocation.
3. No, because such payments are considered rent and must be included in income.
4. No, because a right to receive rent under a lease is not a depreciable asset separate from ownership of the property.

Court's Reasoning

The court reasoned that buyers of used real property generally purchase a unified structure, not individual assets, making it impossible to precisely determine the cost of individual components. The court cited previous cases and IRS rulings distinguishing between new and used property for component depreciation purposes. Fieland did not allocate his cost among the various components of the improvements, instead lumping them together and attempting to depreciate them over the remaining lease term. The court found no "practical certainty" that the improvements would be valueless after the lease, as required for such a short depreciation period. The court also upheld the IRS's allocation of the purchase price, finding Fieland's evidence unconvincing. Rent payments, even if tied to the cost of improvements, were held to be taxable income, not a return of capital. Finally, the court followed precedent in rejecting the amortization of a premium lease, as such a right is not a depreciable asset separate from the property itself.

Practical Implications

This decision clarifies that taxpayers cannot claim component depreciation for existing improvements on used real property without specific allocation and valuation evidence at the time of purchase. Practitioners must carefully allocate purchase prices and document the condition and value of individual components to support such claims. The ruling also reinforces that rent payments, even if structured to recover improvement costs, are taxable income. When purchasing leased property, taxpayers should be cautious about relying on short-term lease provisions to accelerate depreciation, as the useful life of the property itself will generally govern. This case has been cited in later decisions upholding similar principles regarding the depreciation of used property improvements and the tax treatment of lease payments.

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