## **CPA**

## Practice **Advisor**

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

the Enrolled Agent Exam but ended up failing Part I and must take it again. When I asked her what she got wrong, she mentioned basis. Basis is a hard concept to ...

## Craig Smalley • Jun. 04, 2018

I keep in touch with an ex-bookkeeper that I sort of mentored. She decided to take the Enrolled Agent Exam but ended up failing Part I and must take it again. When I asked her what she got wrong, she mentioned basis. Basis is a hard concept to grasp, so I relish the fact that I have basis licked. I even offered to give her a crash course! However, with basis, there are some rules that you just have to memorize.

Basis begins with the purchase of property. This property can be stocks, bonds, mutual funds, or buildings. Pretty much any tangible property. You begin with the purchase price and then you play a game, and that entails the additions to basis. Additions to basis for a security would be commissions, or loads. Additions to basis for buildings, or any other tangible property, are just rules that you're forced to commit to memory.

When someone sells a piece of property to someone, there is usually a closing statement. Our job is to go through that statement. Usually, the property taxes are split between buyer and seller. That is added to the basis of the buyer, and on the seller's side, it is subtracted as an expense of the sale. If the real estate broker commission is split between buyer and seller, that is also added to the basis of the buyer and subtracted as an expense of sale of the seller. Most other things on the closing statement are added for the buyer and subtracted for the seller.

Now, what happens if you buy land and plant almond trees? Wasco Real Properties I, LLC, et al. v. Commissioner, TC Memo 2016-224, is a lesson for all of us. The et al (which is Latin for everyone else) in the suit encompasses three different

partnerships referred to as P1, P2, and P3 in the Official Court Syllabus (R is

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

disallowed the deductions on the grounds that I.R.C. sec. 263A requires that the taxes and the interest be capitalized rather than deducted. R also made adjustments under I.R.C. sec. 481 to reflect a change in method of accounting for each P with respect to the taxes and the interest.

So, what do we have here? We have three partnerships that have either borrowed money from outside financing, or have borrowed money from each other. Interest was paid to the third party, and property taxes were paid on each of the three properties. All of this happened while the trees were being planted and before they bore almonds. These expenses were deducted as interest expenses and property tax expenses. I'm going to ignore the incestuous borrowing of monies from one partnership to the other, without charging the applicable federal rate. However, I am going to address the interest paid to the outside funding source.

In the normal course of doing business, it is reasonable to deduct interest and property taxes. The trees would be producing almonds and the expenses would be a cost of doing business. However, that is not what was going on here. The land was purchased with a loan from an outside source. The trees were planted, and had yet to produce nuts. The interest and property taxes needed to be capitalized, under the Uniform Capitalization Rules.

This is what we are talking about in terms of interest and taxes:

**P1** 

Item 2008 2009

Interest \$792,645 \$564,932

Taxes \$17,232 \$141,022

Sec. 481(a) Adjustment \$61,313

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

**P3** 

Item 2007 2008 2009

Interest \$80,855 \$652,142 \$223,563

Sec. 481(a) Adjustment \$239,935

The Court struggled with the issue of whether the businesses were actively pursuing income. These three partnerships were part of other bigger partnerships that encompassed a complex estate plan. However, the question remains, did the businesses actively pursue income? Further, could the IRC §481(a) adjustment be removed?

First, let's discuss an IRC §481 Adjustment. IRC §481(a) refers to those adjustments necessary to prevent amounts from being duplicated or omitted. It requires them to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. That being said, the partnerships are in clear violation of not using the method of accounting that they were supposed to use (remember that a change in depreciation is a change in accounting method). The Uniform Capitalization Rules, even as revised later in 2013 and 2014, clearly state that items such as interest and property taxes that are paid on property before that property is ready to either move into, in the case of a house or an office building, or produce almonds, like this case, would have to be capitalized. Further, in the case of property that is producing income, it would be depreciated.

Learning basis is certainly a challenge; it's not a simple concept. Hopefully, I can

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

© 2024 Firmworks, LLC. All rights reserved