

**From the desk of  
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## **Tax Court finds loss from sale of property not deductible**

In a recent U.S. Tax Court matter it was found that a taxpayer could not deduct a loss from their sale of real property due to the fact that they failed to establish the cost basis in the property sold.

Losses are not deductible relating to non-business dispositions, therefore taxpayers are not allowed to deduct losses relating to personal property that is not used in the conduct of a trade or business, or from a transaction entered into for profit.

In this specific matter the loss originated from the sale of a property purchased for use as a personal residence, and then later converted to produce to a rental property, which of course is allowable, but in this matter the taxpayers failed to establish the cost basis of the property at the time it was converted to rental property.

Generally an allowable loss from the sale of real property equals the excess of the property's adjusted basis (limited to the property's fair market value) over the amount realized from the sale, but in this matter the taxpayers who rented their second residence failed to follow the rules as to establishing the tax basis of the property, and therefore were not allowed to take the tax loss.

In essence when property which was acquired for personal non-business usage is converted to business use, the taxpayer is required to determine the cost basis of the property for business purposes. Determination of that value must be done by some acceptable valuation process which generally is by a qualified appraiser.

The cost basis for tax purposes is the lower of the cost to acquire the property plus any capital improvements, but must be modified to the market value at the time the property is placed into business usage if the market value is lower than the cost to acquire, plus any improvements. In other words, if the property value has dropped below the cost to acquire plus any improvements, the lower market value is used for tax purposes. This amount will not fluctuate thereafter no matter how the market values change.

In this matter the taxpayers lost their property in 2011 during the height of the last recession the taxpayers lost their property in a short sale (the mortgagee agreed to accept less than the amount they owed on their mortgage). On their tax return for 2011 the taxpayers deducted a loss from the sale of that property.

The Tax Court found that assuming the property was used in a trade or business, the taxpayers failed to establish that their adjusted basis in the property at the time they converted it to a rental property exceeded the amount they realized from the sale.

The Court stated in the published opinion that was issued that the taxpayers incorrectly used the original purchase price which they attempted to use in their tax return of the property.

The correct adjusted cost basis had they properly computed that amount would have been reduced by any loss in value between the time they purchased the property and the time it was converted to a rental, which they had failed to determine by outside valuation, as well as by any depreciation that had been claimed in prior tax returns.

We always suggest an independent appraisal of any property whether inherited, or when personal real estate is converted to business usage so as to provide independent third party verification which is acceptable as being authentic, and dependable, of value at the time inherited, or converted to business usage.

The burden of proof as to the cost basis, whether historical cost, or a lower market value is the responsibility of the taxpayer.

Many we speak to on this matter balk at incurring the cost of doing so, or at the minimum state that they will obtain a real estate agent's opinion as to value. While a real estate agent may have knowledge of what market values might be, they are not considered by the IRS as to being acceptable experts as to valuation.

The tax court in this matter has reinforced the fact that the burden of proof is the responsibility of the taxpayer, and in this case, the taxpayer lost all ability to take what would have otherwise been a loss had they followed the rules.

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