KBKG Insight: Deduct Your Demolished Building Using a GAA

When a taxpayer acquires a building that may need to be demolished in the foreseeable future, they are often disappointed to learn from their tax preparer that they will lose all future tax depreciation deductions associated with the building. For many years, the tax code has not been forgiving to property owners who invest in a building structure and then realize it may not be suitable for future use. In general, the adjusted basis of any demolished building must be capitalized to land which cannot be depreciated.

However, the recently released tangible property regulations provide a potential opportunity to continue depreciating a building after demolition has occurred. To utilize this strategy, however, a taxpayer must elect to include the building in a General Asset Account (GAA) in the year the building is placed in service and comply with all applicable GAA rules. Thus, it is critical for tax preparers to identify this opportunity *early in the process* to properly assess the applicability of this strategy. Furthermore, the benefit of electing a GAA should be weighed against the fact that partial dispositions are not allowed in a GAA.

> **KBKG Insight:** There may be significant permanent tax savings realized by continuing to depreciate a demolished building. If the adjusted basis of the old building is capitalized to land, the basis will not be recovered until the land is sold, resulting in a reduced capital gain. A taxpayer that continues to depreciate a demolished building in a GAA can use those deductions to reduce current taxes at higher ordinary rates—currently 39.6% versus the lower 25% rate applied to depreciated real property in the year of sale. Further, accelerating the deductions generates a time value of money savings.

Current Rules

Code Section 280B provides that "in the case of the demolition of any structure. . . any amount expended for such demolition, or . . . any loss sustained on account of such demolition. . . shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located." The regulations under Section 280B, Reg. Section 1.280B-1(b), further explain that the term "structure" is a building, including its structural components, as defined in Reg. Section 1.48-1(e). Thus, any structures that are essentially items of machinery or equipment, such as oil and gas storage tanks, or blast furnaces, are not required to be capitalized to land when demolished.

> **KBKG Insight**: Because Section 280B only applies to buildings and their structural components, a taxpayer may reduce the adjusted basis of the demolished building and the amount subject to capitalization, by performing a cost segregation study in order to separately identify personal property such as carpet, desks, process plumbing, and special electrical, etc. These items are considered tangible personal property and can be written off over a 5 or 7-year tax life. Also, since personal property can be retired when the building is demolished, cost segregation should be considered regardless of whether the building is put in a GAA.

For situations where only parts of a building structure are demolished, the IRS has provided a safe harbor for purposes of determining whether structural modifications to a building are considered a demolition (see Rev. Proc. 95-27). The safe harbor indicates that modifications will not be treated as a demolition for purposes of Section 280B if: (1) 75% or more of the existing external walls of the building are retained in place as internal or external walls; and (2) 75% or more of the existing internal structural framework of the building remains in place.

Changes Under the Tangible Property Regulations

Under the new tangible property regulations there is no requirement to terminate a GAA upon the disposition of a building. Therefore, a taxpayer that includes a building in a GAA may effectively choose whether to continue to depreciate the building when disposed of or capitalize the adjusted basis to land pursuant to Section 280B.

In general, the adjusted basis of any asset in a GAA (that is disposed of) is determined to be zero immediately prior to disposition. The basis associated with that asset remains in the GAA and continues to depreciate. {See Reg. Sections 1.168(i)-1(e)(2)(i) and (iii)}. Thus, the basis of a demolished building subject to capitalization under Section 280B is zero and the taxpayer continues to depreciate the basis in the GAA. Alternatively, when the last asset in a GAA is disposed of, a taxpayer may elect to terminate the GAA and the adjusted basis of the GAA is subject to all other provisions of the Internal Revenue Code, including Section 280B. {See Reg. Section 1.168(i)-1(e)(3)(ii)}. If only one demolished building is in a GAA and the taxpayer elects to terminate the GAA, the adjusted basis of the building would effectively be capitalized pursuant to Section 280B.

> **KBKG Caution**: This strategy does not work for any building acquired and demolished in the same tax year (Reg. §1.168(i)-1(c)(1)(i)). Additionally, the anti-abuse rules under (Reg. §1.168(i)-1(e)(3)(vii)) are unclear on the extent to which taxpayers can use this strategy if there is clear intent to demolish the building at the time of acquisition.
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> **Case Study**
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> A taxpayer acquires a multi-tenant shopping plaza in February of 2016 for $4 million. The property consists of 3 retail building structures on a large parcel with ample parking. The property is fully leased and each building is in relatively good operating condition. The lease for one of the single tenant buildings (Building A) is set to expire in 2017.
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> In November of 2016, taxpayer is approached by a national restaurant chain that wants to build a new location on the property. The restaurant chain uses a uniquely themed building structure for each location making it impractical to convert any of the existing buildings on site. If an agreement is reached, the taxpayer anticipates demolishing Building A at the end of the lease term and constructing a new restaurant facility for lease to the restaurant chain.
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> Taxpayer conducts a costs segregation study on the 2016 acquired property which allocates $600,000 of value to the Building A structure (depreciated over 39 years) and an additional $90,000 of personal property fixtures within Building A (depreciated with a 5-years tax life). On the 2016 return, the taxpayer elects to put only the Building A structure ($600,000) into a GAA and *does not* put tangible personal property ($90,000) into a GAA.
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> In 2017 an agreement is reached with the restaurant chain. Upon demolition of Building A, the taxpayer is not required under Section 280B to move Building A's remaining tax basis to land, but he continues to depreciate the building each year going forward. This generates a net present value of $72,000.* Further, taxpayer claims a retirement loss deduction on the remaining basis from the $90,000 of 5-year property, generating an additional net present value of $34,000.*
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> *Assumes a combined federal and state income tax rate of 40%, an 8% discount rate, and the property is never sold.

Compliance with GAA Rules
While continuing to depreciate the basis of a demolished building may be favorable, a taxpayer that elects to include the building in a GAA must apply all of the applicable GAA rules. Additional items to consider when deciding whether to make a GAA election include:

Timing. In general, a GAA election must be made on a timely filed return for the year the asset is placed in service. Thus, it is critical for tax preparers to identify this opportunity early in the process to appropriately consider all facts and circumstances.

How to make a GAA election. The election is made by checking the applicable box on Line 18 of Form 4562 and by including a statement in the taxpayer's records that identifies the assets included in each GAA. This statement does not need to be included with the tax return.

Partial dispositions are not available for assets included in a GAA. The GAA rules require that a taxpayer continue to depreciate the basis of the asset(s) included in the GAA until all assets in the GAA are disposed of. Thus, a taxpayer that replaces items such as windows or lighting may not claim a partial disposition loss. This is one of the main reasons it is generally not appealing to make a GAA election for a building.

How many assets may be included in a GAA? In general, a taxpayer may include in a single GAA as many or as few assets as are placed in service at the same time and depreciated using the same recovery period, convention, method, bonus depreciation election, etc. {See Reg. Section 1.168(i)-1(c)(2) for additional requirements}.

> **KBKG Insight:** Where multiple buildings are purchased on one property, consider making the GAA election only for the building that will be demolished. In this way, only the specified building is subject to the potentially unfavorable GAA rules. In addition, if a GAA election is desired for all building structures, the greatest flexibility is afforded when each structure is included in a separate GAA.

Subsequent additions may not be included in the original building's GAA. Any additions to an asset included in a GAA may not be added to the original GAA. A taxpayer may make a separate GAA election for such assets or may choose to depreciate the addition(s) without making a GAA election.

Closing
Losing the benefit of depreciation deductions, due to the demolition of the building, never feels good to a property owner. However, the recently released tangible property regulations provide a potential opportunity to preserve those deductions. In situations where a building is acquired that could potentially be demolished in the foreseeable future, the GAA election should be carefully considered *in the year it is placed in service* and *before the original tax return is filed.*

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