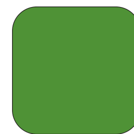
Reprinted with permission from Construction Accounting & Taxation



SAVING DEPRECIABLE TAX BASIS FROM DEMOLITION

Purchase price allocation may be less significant if a building is ultimately demolished, unless rules issued recently can be taken advantage of by the new owner.

LAURA JACKSON AND SCOTT DRAGO

During the last few years, downward pressure on cap rates, historically low interest rates, and readily available debt have caused the commercial real estate market as a whole to appreciate substantially. While lower-tier markets may not have reached their pre-recession price levels, some may say that first-tier markets are showing early signs of overheating.

Given the cap rates for Class A properties in top-tier markets, real estate professionals have begun to look at buildings that may be a little "long in the tooth" and in need of significant improvements, if not complete demolition. Given the right circumstances, this type of investment may provide superior returns compared to investing in a building that is closer to the beginning of its life cycle.

When acquiring a property that eventually may be demolished, there are significant tax consequences to consider.

Allocation of purchase price

When land and a building are purchased together for a lump sum, it is necessary to apportion part of the purchase price between the land and the building. Generally, the total purchase price is allocated between the land and the building based on their relative fair market values.[1] Buyers and sellers may have differing opinions on how much of the purchase price to allocate between land and building. Sellers may want to allocate more purchase price to land because land is not depreciable, and any gain on the land should be subject to a lower capital gains rate.[2] The sale of a building, which is subject to depreciation, would be subject to higher tax rates under certain "recapture" rules.[3]

A buyer, on the other hand, will want to allocate more to the building because buildings generate depreciation deductions that will reduce future taxable income. In addition, a buyer may want to have a cost segregation study (or "cost seg") to further allocate the purchase price for the building among its various subcomponents. Many subcomponents have shorter depreciable lives, resulting in increased depreciation deductions early on. While a third-party appraisal of the land and the building is the safest bet to withstand a challenge by the IRS, a careful and reasonable allocation of the purchase price may be accepted provided the parties can show the allocation was based on arm's-length negotiations.

LAURA JACKSON *is a managing director in the tax practice of the Real Estate & Infrastructure Solutions industry group at FTI Consulting, Inc. She can be reached at* laura.jackson@fticonsulting.com.

SCOTT DRAGO *is a senior director in the tax practice of the Real Estate & Infrastructure Solutions industry group at FTI Consulting, Inc. Contact him via email at* scott.drago@fticonsulting.com.

In addition, what if the buyer intends to demolish the building? What is a reasonable amount of the purchase price to allocate to the building? If the building is no longer in service, then it may be difficult to argue that any significant amount of the purchase price should be allocated to the building. On the other hand, if the building is operating in the normal course, then the buyer's intent to eventually demolish the building may not have as much of an impact on the purchase price allocation between land and building. This will depend on all the facts and circumstances. However, as discussed in the following paragraph, the purchase price allocation may be less significant if the building is ultimately demolished, unless rules issued recently can be taken advantage of by the new owner.

Demolition and tax basis

Prior to 1984, the demolition of a building typically resulted in a loss deduction for the owner equal to the remaining basis in the building (plus costs of demolition, less any salvage value).[4] As mentioned previously, this rule was subject to a major exception. If the property was acquired with the intent to demolish it either immediately or at a later date, then the entire purchase price was allocated to the land and no loss would result upon demolition.[5] Treasury Regulations look to all the facts and circumstances surrounding the buyer's intentions for the building to determine whether the purchase price should be allocated solely to the land. [6]

WHEN A BUILDING IS DEMOLISHED, THE ADJUSTED BASIS OF THE BUILDING (AND THE COST OF DEMOLITION) LESS ANY SALVAGE VALUE MUST BE CAPITALIZED AND ADDED TO THE BASIS OF THE LAND.

Internal Revenue Code Section 280B

The subjective test used to determine a buyer's intended use (or lack of use) of a building was perceived as difficult to apply in the real world and often resulted in tax litigation. As a result, Congress enacted IRC Section 280B.[7] Under that section, when a building is demolished, the adjusted basis of the building (and the cost of demolition) less any salvage value must be capitalized and added to the basis of the land. The basis of the new building only includes the cost of new construction.

However, amounts spent modifying a building are not subject to Code Section 280B. Any modifications are added to the basis of the old building and not to the land. For purposes of this exception to Code Section 280B, a building has been modified (as opposed to demolished) if (1) at least 75 percent of "the existing external walls of the building are retained in place as internal or external walls" and (2) at least 75 percent of "the existing internal structural framework of the building is retained in place."[8] This is an important exception to the bright-line rule under Code Section 280B.

Case law exceptions to Code Section 280B

It is important to keep in mind that Code Section 280B does not prevent a taxpayer from taking a loss deduction on a building that results from an unexpected retirement of the building prior to any decision to demolish it. In the *De Cou* case, the taxpayer purchased real property in 1984 with the intention of renovating two of the buildings and leasing a third. [9] Serious defects in one of the buildings were discovered in 1985 and certain permits were revoked. It was determined that the building was not commercially viable without significant repairs (which would cost twice as much as constructing a new building). As a result, the taxpayer decided to retire the property, but no efforts to sell the property were made. The same year in which the defects were discovered and the building was taken out of service, the taxpayer had the building demolished. On the taxpayer's 1985 tax return, an ordinary abandonment or retirement loss was taken, which the IRS disallowed.

The Tax Court sided with the taxpayer and allowed the loss deduction. In finding for the taxpayer, the Tax Court noted that the unexpected revocation of the building's permit and withdrawing the building from use due to the discovery of severe structural issues was the cause

of the loss, not the demolition of the building. Therefore, the deduction was not barred by Code Section 280B. The key to the Tax Court's decision was the fact that the property was withdrawn from use and there were no efforts to sell the property.

On the other hand, the 3rd Circuit in *Gates, Linden v. U.S.* found that a taxpayer was not entitled to a loss deduction on a building that was subsequently demolished.[10] In *Gates*, the taxpayer acquired a building in 1984 with the intent to renovate and lease it. In 1988, asbestos was discovered and extensive damage from vandalism occurred. The renovations were never made, and the building was marketed for lease or sale until 1989. In 1991, the building was demolished. In denying the taxpayer's loss deduction, the 3rd Circuit emphasized that the loss (asbestos and vandalism) occurred in 1988, but the deduction was claimed in 1991. As important, the building was never abandoned, as the taxpayer continued to market it for lease or sale. Therefore, a taxpayer intending to claim a loss deduction for a demolished building must identify and document the event that created the loss, claim the loss in the appropriate tax year, and discontinue all marketing of the property. The *Gates* case shows that, while hindsight may be 20/20, it doesn't help with a loss deduction when a building is demolished. Foresight is the key.

Tangible property regulations

The recently finalized tangible property regulations (or TPRs) are one of the most significant (if not the most significant) tax developments affecting the real estate industry since the Tax Reform Act of 1986. The TPRs touch on almost every aspect of owning and operating real property. While the TPRs are intended to provide taxpayers certainty on the proper tax treatment of materials, supplies, repairs, and dispositions of real property, they have also provided many opportunities for tax planning.

One such opportunity provides the potential to avoid rolling over a demolished building's remaining basis into land under Code Section 280B.[11] Pursuant to the TPRs, a taxpayer that anticipates demolishing a building may place the building into a single-asset general asset account (GAA) and continue to depreciate the building even after the building is demolished instead of rolling over the remaining adjusted basis of the building into the land as otherwise required by Code Section 280B.[12]

According to the TPRs, a taxpayer is not required to terminate the GAA upon demolition of the building. Therefore, even after the building is demolished, a taxpayer would continue to depreciate the remaining adjusted tax basis as if the building was still standing.

GAA elections are relatively uncommon because they typically lock in the basis of a property and keep a taxpayer from realizing losses on the disposition of assets. Disposition of an asset that is part of a GAA generally does not result in a tax loss to the taxpayer. It continues to be depreciated as part of the GAA until the GAA balance is $0. However, a single-asset GAA can be used to a taxpayer's advantage when it is desirable to continue depreciating the property even after its disposition, such as a demolition where the building's basis would otherwise be rolled into the land.

It should be noted that the election to place a building into a single asset GAA is only available for current and future years in which a property is acquired.[13] Further, the election to place a building into a GAA is not available for buildings that are acquired and disposed of within the same year.[14] As with the cases discussed previously, a taxpayer must plan ahead and keep the proverbial eye on the wrecking ball in order to make a timely GAA election.

This new rule allowing for the continued depreciation of a demolished building would benefit taxpayers in the current marketplace. Given current real estate valuations, commercial real estate owners may begin to look for opportunities to acquire "tired" buildings that are in prime locations, demolish the existing structure, and rebuild. Placing the old building in a GAA would allow the taxpayer to continue to depreciate the old

building after demolition, instead of rolling the building's adjusted tax basis into land only to realize a tax benefit from the increased basis in the land upon disposition. The TPRs essentially allow a taxpayer to deduct two buildings (the demolished building now in the GAA and the new building once construction is complete). ■

NOTES

[1] Treasury Regulation § § 1.61-6(a) and 1.167(a)-5.

[2] This assumes the seller is not in the trade or business of selling property and has held the property for investment purposes.

[3] "Recapture" is a bit of a misnomer in that the gain is not re-characterized as ordinary income (assuming straight-line depreciation has been taken), but the amount of gain equal to prior depreciation taken would be subject to a higher 25 percent capital gains rate. However, any accelerated depreciation taken on components of a building may cause gain allocated to those components to be treated as ordinary income.

[4] Treasury Regulation § 1.165-3(b)(1). However, under Treasury Regulation § 1.165-3(b)(2), demolition of a building subject to a lease requires the remaining tax basis in the building to be added to the lease cost and amortized over the remaining term of the lease.

[5] Treasury Regulation § 1.165-3(a).

[6] Treasury Regulation § 1.165-3(c)(1) and (2) set out a long list of factors to be considered.

[7] All references to the "Code" herein are to the Internal Revenue Code of 1986, as amended; Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 1178 (Comm. Print 1984).

[8] Rev. Proc. 95-27, 1995-1 CB 704.

[9] 103 TC 80 (1994).

[10] *Gates, Linden v. U.S.,* 82 AFTR 2d 98-6909 (168 F.3d 478), Code Sec(s) 165; 167; 280B, (CA3), 10/09/1998.

[11] This assumes that a loss on demolition is not available under the case law discussed previously.

[12] Treasury Regulation § 1.168(i)-1(e)(3)(ii)(A).

[13] This is because the period for filing late accounting method changes for previously acquired property under the TPRs has closed. For example, a taxpayer that acquired a property in 2011 and is about to begin demolition would not be entitled to make an election to place that property into a GAA and continue depreciation.

[14] Treasury Regulation § 1.168(i)-1(c)(1)(i).