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Introduction to Demolition Studies

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– David McGuire
Director
McGuire Sponsel

McGuire Sponsel would like to cover the changes in the IRS position as it relates to demolition studies. For years the IRS took the position that a "portion of a larger structural asset" could not be abandoned when removed. This meant that if a taxpayer were to remove a roof or wall as part of a renovation project, the original roof or wall had to be left in place. This led many taxpayers to have multiple roofs, HVAC systems, or lighting systems on the books. In previous years many cost segregation providers tried to sell abandonment studies, calling them different names such as demolition studies or asset management studies. According to the IRS, this was not allowed and would have been denied upon audit. All of this changed under the final regulations.

The final regulations allow for a portion of a larger capital asset to be written off when it is removed as part of a new capital project. If a HVAC system is replaced as part of a capital project the original HVAC system may be eligible for removal. This allows the taxpayer to write off the remaining basis in the current tax year instead of depreciating over the remaining useful life. It is important to note that the replacement needs to be a capital replacement and not a repair. If the replacement is done as a repair there is no offsetting capital project and the original depreciable asset will remain on the books.

This type of project intersects well with the 179D regulations. If a taxpayer replaces the lighting system as part of an energy efficient upgrade, they will most likely be eligible for the 179D savings under EPAct. The savings typically traditionally ended there. However, under the final regulations the taxpayer can also write off the original lighting system, as it is now abandoned. This can significantly increase the tax savings generated by upgrading a facility.

The IRS recognizes that this is a change from prior regulations and is allowing for a retroactive recapture of past benefits as a direct result of partially disposed assets. Through a change in accounting method, assets that were removed in the past could be written off in the current year. However, with the issuance of Rev. Proc. 2014-17, a partial disposal is now considered to be a current year election. This means that going forward, taxpayers will not be able to retroactively recapture past benefits on partially disposed assets. In order to capture potential cash flow benefits from retroactively claimed partially disposed assets, the change in accounting method must be filed no later than the 2013 tax return extension due date.

A few pitfalls do exist under these new regulations. The biggest one is that you cannot purchase a building, renovate it immediately and take an abandonment loss on the assets removed. In this situation the IRS takes the position that the assets being removed had little or no value at the time of purchase.

These regulations make it more important than ever to have a detailed engineering based cost segregation study completed on any building placed in service. The cost segregation study should detail the assets placed in service, including any real property. This will provide a basis for the removal later in the properties life.

Should you have any questions about these regulations and how they relate to your situation please feel free to contact McGuire Sponsel.

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201 N. Illinois Street, Suite 1000 | Indianapolis, IN 46204 | (317) 564-5000 | www.mcguiresponsel.com