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Tax Implications of Owning Your Corporate Headquarters

You own a successful construction company and the lease on your corporate headquarters is ending – do you sign a new lease or do you buy your next property? This article covers the various tax benefits and implications to consider.

Entity Structure

The first issue to consider is who or what entity will own the new property. Attorneys and tax advisors often recommend forming an LLC to purchase real estate. The attorney's perspective includes the view that investments in real estate should be held separate from the primary operating entity (or entities) for asset and liability protection.

While discussing all aspects of limiting legal risk is beyond the scope of a tax article, mitigating legal risk is a main reason for utilizing an LLC rather than a corporation, whether it be a C corporation or an S corporation. In many states there are legal advantages for an LLC compared to corporations.

For tax advisors, an LLC is generally favorable because of certain unique tax issues. The default tax reporting of an LLC that has multiple members is as a partnership. Partnerships have advantages over S corporations regarding the calculation of owners' tax basis; unlike S corporations, partnerships treat members' shares of the entity's liabilities as if they were the same as cash contributions.[1] We'll see shortly how this increased tax basis assists with deducting potential tax losses.

In general, for tax purposes, land and buildings are generally better if owned by an LLC and taxed as a partnership when there are multiple members.

Depreciation

A primary tax benefit of owning real estate (as opposed to renting) is the non-cash depreciation expense. IRC §168 allows owners to allocate the cost of their investment by depreciating nonresidential real property, such as commercial buildings, using the straight line method[2] over 39 years.[3]

While this helps business owners reduce taxable income and tax by annually deducting approximately 2.5% of the depreciable cost, the full tax benefit of the depreciation deduction is realized over 40 years,[4] which is a long time for most businesses. Many property owners undertake a cost segregation study (CSS) to accelerate the depreciation deduction.

Cost Segregation Study

A CSS is a multi-disciplinary tax and engineering study that is used to identify the individual components of a property and segregate them into asset classes with shorter depreciable tax lives than the previously mentioned 39-year tax life. The objective is to determine what costs can be depreciated over five, seven, or 15 years. While it is often beneficial to perform a CSS when a building is first purchased, it is not a requirement; a study can be completed in a later year. When the CSS results are reported after the initial year in which the building is placed in service, taxpayers must file a Form 3115 with their tax return to report a change in accounting method to enable the "catch-up" depreciation deduction.

For example, consider a property placed in service in 2014 and a CSS completed in 2019. Assume that the study identifies $50,000 of a five-year property that should have been depreciated in full prior to 2019. The owners can file a Form 3115 and deduct the entire $50,000 less the amount already deducted under the prior 39-year class life. The result is "catch-up" depreciation of $43,750 ($50,000 less $6,250, which is 2.5% of the $50,000 for five years, notwithstanding the initial short-year depreciation).

For an in-depth discussion of CSS, refer to "Understanding Cost Segregation Studies & Potential Tax Benefits" in the March/April 2016 issue of *CFMA Building Profits*.

Bonus Depreciation

While a CSS is useful to identify component assets' depreciable lives and accelerate depreciation expense, the effects are magnified by bonus depreciation. Effective for assets placed into service after September 27, 2017, businesses can deduct 100% of the cost of assets with class lives of 20 years or less. The current availability of bonus depreciation phases out after 2026.

The most significant opportunity here is that bonus depreciation after the effective date can be claimed on both new and used property. Prior to the enactment of the new law, only new property qualified.

What does this mean to the business owner? Consider, for example, Robert and Bob, a father and a son who each own 50% of XYZ Construction, Inc., an S corporation GC. They form Headquarters, LLC (with the same ownership percentage) to purchase XYZ Construction, Inc.'s new corporate headquarters for $4.9 million on January 1, 2019. Robert and Bob each contributed $245,000 toward the purchase, while Headquarters, LLC took a mortgage for the remaining $4.41 million.

Assuming $1 million of the cost is allocated to the land, which is generally not depreciable, the building would normally be depreciated over 39 years at approximately $100,000 per year (notwithstanding the initial short-year depreciation). Of the $3.9 million depreciable cost, a CSS identified $450,000 of 5-year assets and $1 million of 15-year assets. As a result, the 2019 depreciation expense will be approximately $1,510,203:

One hundred percent (100%) of the five- and 15-year assets, or $1.45 million, plus the remaining $2.45 million, depreciated over 39 years, using the mid-month convention for the first month in service, or $60,203.

Obviously, the first year depreciation deduction of $1,510,203 is significantly higher than annual depreciation of approximately $100,000 previously referenced (i.e., without the CSS). Also, the result is superior to a CSS performed before the *Tax Cuts and Jobs Act* (TCJA) of 2017 when accelerated depreciation was permissible, but now bonus depreciation applies to the "used" assets acquired.

If Robert and Bob had formed an S corporation instead of an LLC to purchase their new headquarters, their allowed loss for 2019 (assuming the entity broke even on rental income and expenses before depreciation) would be limited to their respective basis of $245,000 each. They wouldn't be able to take full advantage of the accelerated depreciation determined by the CSS. However, because the taxpayers formed an LLC, their basis for tax loss purposes includes the borrowed mortgage funds.[5] Thus, each member has a tax basis of $245,000 *plus* one-half of the outstanding mortgage at year-end, enabling each member to deduct the entire taxable loss for 2019 (notwithstanding passive activity loss limitations), which includes the full allocable depreciation. If the loss is large enough that Robert and Bob are each respectively in a tax loss position, the net operating loss that is generated at the individual level is carried forward.

Leasehold Improvements Deductible as Section 179 Expensing

Prior to the TCJA, certain building improvements were included in special asset classes that were depreciated over 15 years, including qualified leasehold improvement property. In addition to the shorter depreciation period (as compared to 39 years), the 15-year property was also eligible, within specific limitations, for a Section 179 deduction. Section 179 permits an election to immediately expense tangible, depreciable assets, with certain limitations and thresholds.

The TCJA consolidated the various qualified asset categories into one called qualified improvement property (QIP), which generally includes any improvement to the interior of a nonresidential building that is placed in service, but does not include: improvements for an elevator/escalator, the expansion of a building, or expansion to a building's structural framework.[6]

With the rush to implement the tax law at the end of 2017, lawmakers inadvertently eliminated the prescribed 15-year class life for these improvements. So, unless a future technical correction is signed into law, QIP defaults to the same class life as nonresidential real property, which is 39 years *and* is not eligible for bonus depreciation.

The big takeaway is that the new category omits the word "leasehold." Thus, the new category includes all qualified property, regardless if the building is leased or not. So, in the common scenario where an LLC leases a building to an operating company owned by related parties, either the lessor *or* the lessee can elect the Section 179 deduction for the improvements meeting the QIP definition.

Here are a few of the key limitations under Section 179. The Section 179 deduction is subject to a maximum of $1 million on a total of no more than $2.5 million of eligible Section 179 property in a single year. The limitation is decreased, dollar-for-dollar, to the extent that eligible Section 179 property exceeds the $2.5 million threshold. Thus, if a taxpayer adds $3.5 million of eligible Section 179 property, the deduction will be fully limited. Moreover, the taxpayer must have taxable income to take the benefit of the Section 179 deduction. Thus, generally, the operating company installs and depreciates the leasehold improvements.

For a more detailed review of depreciation and the Section 179 deduction see "The Various Buckets of Depreciation: Current Rules & Changes" in the May/June 2018 issue of *CFMA Building Profits*.

Passive Losses

The common entity structure discussed whereby contractors maintain their construction operating activities in separate taxable entities from their real estate is generally a byproduct of standard legal advice to compartmentalize potential legal risk. A result on the tax side is that the passive activity loss (PAL) rules generally and unintentionally limit losses from the real estate partnership. While maximizing the timing of tax depreciation and losses helps cash flow, legal issues generally supersede these concerns as previously mentioned, and therefore addressing PAL limitations becomes a necessary exercise.

A passive activity is any activity in which the taxpayer doesn't materially participate, including all rental activities.[7] The consequence to the contractor is that PALs are limited to the extent of passive income.[8]

Continuing with the previous example, XYZ Construction, Inc. generates pass-through nonpassive taxable income of $2 million, and Headquarters, LLC generates pass-through PAL of $1,510,203. Here, the general rule would be that the entire PAL would be disallowed and each taxpayer would be taxed on his allocable share from the S corporation of $1 million.

Grouping Passive Activities

A permissible election helps this situation by grouping a taxpayer's rental activities with other active business activities *if* the activities constitute an appropriate economic unit.[9] Treasury Regulations specify a facts and circumstances test to measure the appropriateness and enumerate several (not all-encompassing) factors:[10]

1) Similarities and differences in types of trade or business

2) The extent of common control

3) The extent of common ownership

4) Geographical location

5) Interdependencies between or among the activities

Further limitations of the grouping election include that the rental activity must either be insubstantial in relation to the business activity (or vice versa) or that each owner of the business activity has the same proportionate interest in the rental activity.[11]

Applying the facts and circumstances test to our continuing example, the control and ownership of both XYZ Construction, Inc. and Headquarters, LLC are the same, their geographical locations are the same, and the entities are highly interdependent (i.e., XYZ Construction, Inc. rents from Headquarters, LLC, which doesn't rent to any other tenants).

Furthermore, Headquarter, LLC's activity is insubstantial in relation to XYZ Construction, Inc.'s operations. Therefore, it would be appropriate to group both activities by election under Regulation 1.469-4(d)(1), in which case XYZ Construction, Inc.'s taxable income will be offset by Headquarters, LLC's PAL for a net taxable income of $489,797 ($2 million less $1,510,203).

The catch is that the election to group activities must be made in the first year that those activities are reported. The Regulations state that "unless a taxpayer's original grouping was clearly inappropriate or [if] a material change"[12] occurs, a taxpayer cannot regroup its activities in subsequent tax years. So, if a taxpayer neglects to make the proper election in the first year, subsequent losses in following years will be considered PALs subject to the limitations previously discussed.

Self-Rental

An unusual circumstance occurs when the rental activity, which is passive by definition, produces taxable income rather than taxable loss. The PAL rules previously covered are not applied consistently when it comes to income generated by passive rental activities. The common circumstances described between XYZ Construction, Inc. and Headquarters, LLC are characterized as self-rentals under the regulations; in such cases, taxable income is treated as though it is from a nonpassive activity. So if the taxpayer were to have PALs from other activities, then he/she would not be able to offset those other PALs with the nonpassive taxable rental net income from a self-rental.[13]

Sales of Real Property

Depreciation Recapture

A tax consequence of which business owners must be aware is depreciation recapture.[14] When selling real property at a gain, capital gains tax at a rate of 25%[15] applied to the portion of gain attributable to the prior depreciation expense. This 25% recapture rate is higher than typical capital gains rates, which generally range from 0-20% depending on the member's income levels.

Since business owners' tax benefits from depreciation is generally their marginal individual income tax rates, which can now be as high as 37%, lawmakers established the provision for depreciation recapture as a means to bridge the

gap between the two rates. That is, with a deduction that can be at a relatively higher marginal rate, theoretically, you shouldn't get the entire benefit of lower capital gains rates. This 25% rate applies to the depreciation on the building itself (i.e., generally 39-year property). Any assets sold on which accelerated depreciation was deducted is taxable as ordinary income at the time of sale.

For example, 10 years after acquiring the building, Headquarters, LLC sells the property for $7 million. Here we find several types of potential taxable gains and recapture. Assuming the basis at the time of sale is $2.822 million, the total gain is $4.178 million.[16] Gains are reported as follows:

- Section 1250 recapture: building depreciation of approximately $628,000, taxed at 25%.
- Bonus depreciation of $1.45 million, taxed as ordinary income.
- The remaining $2.1 million gain,[17] taxed at capital gains rates from 0-20%. The rate depends on the taxpayer's income for the taxable year of the sale.
- A potential 3.8% investment income surtax may apply based on the taxpayer's taxable income and whether the gain is an investment in nature to the LLC member.

Thus, the potential for pure capital gains rates applies to the appreciation on the building and land; whereas other rates may apply where depreciation was deducted.

Section 1031 Exchange

IRC Section 1031 permits taxpayers to postpone the recognition of gain or loss on the exchange of business real property for other like-kind business real property.[18] This opportunity may postpone most, but not necessarily all, capital gains on the sale of a building. Prior to the TCJA, tangible personal property was eligible for like-kind exchange treatment, but the provision now only applies to real property. So, a taxpayer that undertakes a CSS must be cognizant of how it structures a building sale so as to mitigate taxable gain on the non-real property identified by the earlier study.

Sales Tax

An ancillary tax applicable to self-rentals in many states is sales tax. Sales tax rules vary by state and smaller municipalities. Many states do not specifically tax commercial rent, while others do not assess tax on rents below certain thresholds. Business owners should consult with their tax advisor for applicable sales tax implications. This is another trade-off of maintaining corporate property in a separate entity for risk/legal mitigation purposes.

Conclusion

Contractors that own their corporate headquarters can build equity, increase cash flow, and reduce income tax liabilities. At the same time, entities must be properly established and tax elections timely filed. There are many other issues to consider such as tax ramifications of refinancing the property's mortgage, distributing net funds available after refinancing, addressing the purchase of a partial interest whereby a new member buys into the LLC, new rules regarding parking lots, etc. To take full advantage of the tax opportunities associated with their corporate headquarters, CFMs should secure advice from their tax advisor. ■

Endnotes

1. IRC §752.
2. IRC §168(b)(3)(A).
3. IRC §168(c).
4. Partial-year depreciation is deducted in year one and year forty.
5. Assumed to meet the at-risk qualified nonrecourse debt requirements under IRC §165.
6. IRC §168(e)(6).
7. IRC §469(c)(2).
8. IRC §469.
9. Reg. §1.469-4.
10. Reg. §1.469-4(c)(2)(i) through (v).
11. Reg. §1.469-4(d)(1)(i)(A) through (C).
12. Reg. §1.469-4(e).
13. Reg. §1.469-2(f)(6).
14. IRC §1250.
15. IRC §1(h)(1)(E).
16. $7 million sale price less net book value of $2.822 million ($4.9 million original purchase price, less $1.45 million bonus depreciation, less $628,000 regular depreciation). Closing costs are not included for simplicity.
17. $4.178 million gain, less $1.45 million bonus depreciation, less $628,000 regular depreciation.
18. IRC §1031(a).

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