

The Impact of Depreciation Recapture on Exchanges

Depreciation is an integral part of calculating the adjusted basis of property, and thus is an important component of the non-recognition provisions of IRC §1031. The calculation of gain from the sale or exchange of an asset is based in part on the depreciation calculation associated with that particular asset.

Depreciation in the Internal Revenue Code (“Code”) is a means of allowing the taxpayer a reasonable deduction for the exhaustion, wear, and tear of business use property (not property held for personal use). When business use property is sold or exchanged, the Code requires the depreciation previously taken by the taxpayer to be “recaptured.” Upon the disposition of the taxpayer’s property, depreciation recapture is that portion of the gain subject to taxation to the extent the taxpayer recovers the depreciation deducted in prior tax years. All business use property is subject to depreciation recapture. The recapture provisions, however, are different depending on whether the asset being sold or exchanged is real or personal property.

IRC §1250 property is generally defined as improved commercial real estate and is real property subject to a depreciation deduction on the taxpayer’s return. The recapture provisions applicable to §1250 property are fairly complex but essentially make a distinction between property placed in service by the taxpayer before 12/31/86 (“Pre ’87 property”) and property placed in service after that date (“Post ’86 property”). Pre ’87 property is §1250 property that generally used an accelerated cost recovery method of depreciation.¹ For §1250 property, any depreciation taken under ACRS in excess of the depreciation that would be allowed under a straight-line cost recovery method is taxed as ordinary income and any gain attributable to unrecaptured depreciation under straight-line depreciation (“unrecaptured §1250 gain”) is currently taxed at 25%.

The Tax Reform Act of 1986 eliminated accelerated depreciation and required all real property to use straight-line depreciation under the modified accelerated cost recovery system (“MACRS”). Accordingly, most §1250 property is Post ’86 property and, thus, when it is sold or exchanged it is not subject to excess depreciation recapture (at ordinary income tax rates). As with Pre ’87 property, unrecaptured §1250 gain on Post ’86 property is taxed at a 25% federal tax rate and any gain in excess of the depreciation taken is taxed at the current 15% federal capital gain rate.

Example:

Facts: Taxpayer transfers a Post ’86 office building with an adjusted basis of \$100,000 for a fair market value of \$1,000,000. Over the years the Taxpayer has taken \$500,000 in depreciation deductions.

- i) In an outright sale the Taxpayer will recognize a total gain of \$900,000 (\$1,000,000 - \$100,000). \$500,000 will be unrecaptured §1250 gain taxed at 25%. \$400,000 will be considered capital gain taxed at 15%.
- ii) Assume the Taxpayer’s building was a Pre ’87 property and \$200,000 of the depreciation was subject to recapture as “excess depreciation”. The Taxpayer will recognize \$200,000 of depreciation recapture taxed as ordinary income at the Taxpayer’s marginal tax rate. The remaining \$300,000 of depreciation will be unrecaptured §1250 gain taxed at 25%, and the remaining \$400,000 of gain will be considered capital gain taxed at 15%.
- iii) If, however, the Taxpayer exchanges the building into another commercial real estate asset valued at \$1,000,000 in a §1031 exchange transaction, he will defer all of the gain arising from the disposition of his office building.

IRC §1245 property is generally depreciable personal property, although the Code does classify certain types of real property placed in service prior to 1987 as §1245 property. Currently, §1245 property is only personal property used in a trade or business. Dispositions of §1245 property that result in a gain are subject to depreciation recapture. Unlike §1250 property, however, recaptured depreciation on §1245 property is not entitled to a preferential lower tax rate. Under §1245, all depreciation that has been taken on the subject property must be recaptured and taxed as ordinary income, but only to the extent that gain is recognized on the sale or exchange transaction. In a §1031 exchange transaction, any recaptured depreciation will only be taxed to the extent that §1031 requires taxable boot to be recognized. Any gain recognized in excess of the recaptured §1245 depreciation is considered a capital gain and is currently taxed at 15%.

¹ An accelerated cost recovery system (“ACRS”) allows a taxpayer to deduct the largest portion of the property’s cost in the initial years of its service. This depreciation method was intended to more accurately reflect the actual rate of diminution in value of the asset.

Brief Exchanges

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The Impact of Depreciation Recapture on Exchanges (Continued)

Example:

Facts: Taxpayer disposes of a construction crane (§1245 property) with an adjusted basis of \$5,000 for a fair market value of \$40,000. Since its acquisition, the Taxpayer has taken \$45,000 in depreciation deductions as allowed under MACRS.

- i) In an outright sale the Taxpayer will recognize total gain of \$35,000 (\$40,000 - \$5,000). All of that gain will be taxed as ordinary income to the taxpayer.
- ii) If the Taxpayer were to dispose of the crane in a §1031 exchange transaction for another crane with a value of at least \$40,000, no gain would be recognized.
- iii) If, however, the Taxpayer were to dispose of the crane in a §1031 exchange transaction for another crane with a value of only \$30,000, then \$10,000 of gain will be recognized as taxable boot in this exchange. It will be considered depreciation recapture under §1245 and taxed as ordinary income at the Taxpayer's marginal tax rate.

Recently, some owners of large properties have utilized a "cost segregation" study as a means of maximizing the benefits of both like kind exchanges and accelerated depreciation. A cost segregation is a detailed engineering study that reapportions §1250 (real) property to §1245 (personal) property. Generally, the taxpayer orders the study after the acquisition of §1250 property. The goal is to strictly analyze the acquired property and carve out, according to IRS standards, any §1245 property included in the property. As a result, the taxpayer is able to take advantage of the more generous accelerated depreciation provisions available to personal property. (See IRS CCA 200648026). When a taxpayer exchanges improved real property for which cost segregation has been utilized, care must be taken to ensure that the replacement property will have sufficient §1245 property to offset §1245 recapture, in addition to having sufficient §1250 property to offset §1250 recapture, otherwise boot will be recognized. In other words, if the relinquished property has been cost segregated, then a cost segregation study will also be required for replacement property. It is important to note that cost segregation does not convert an exchange of a single asset of improved real property into a multiple asset exchange.

Another important depreciation concept relates to the correct method of depreciating property acquired in a §1031 exchange. In January, 2000 the IRS issued guidance on this topic by requiring the exchanged basis² of replacement property to be depreciated over the remaining recovery period, and using the same depreciation method and convention as that of the relinquished MACRS property. Any excess basis is to be treated as a new asset and depreciated accordingly. This method – commonly referred to as "step in the shoes" depreciation – remained in effect for four years.

In March, 2004 the IRS revised the rules for step in the shoes depreciation to eliminate any tax advantage of acquiring replacement property with a longer recovery period or slower accelerated depreciation method than the relinquished property it replaced. Treasury Regulation §1.168(i)-6T requires exchanged basis to be recovered over the remaining life of the **relinquished** property using the same method that was used for the relinquished property if the replacement property has the same or shorter recovery period or the same or more accelerated depreciation method. Alternatively, the regulation requires exchanged basis to be recovered over the remaining life of the **replacement** property utilizing the depreciation method of that replacement property if it has a longer recovery period or a less accelerated depreciation method. In summary, the IRS wins both ways. Property acquired in an exchange must now be depreciated using the recovery period and method applicable to either the relinquished or replacement property, whichever is less advantageous to the taxpayer.

Depreciation issues are very complex and are an integral part of calculating taxable gain. It is important to understand the different tax consequences of depreciation recapture and capital gain associated with real and personal property. For a more complete understanding of the depreciation issues associated with the sale or exchange of an investment or business use property, Exchangers should consult their legal and tax advisors.

² Exchanged basis is equal to the adjusted depreciable basis of the relinquished property.

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