Impact of Depreciation Recapture on Exchanges

IPX 1031®

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. Depreciation is a means of allowing the taxpayer a reasonable deduction for the exhaustion, wear, and tear of business use property. 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 applies to that portion of tax gain attributable to sale proceeds received up to the amount of depreciation taken over the life of the asset. 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 real property that is subject to a depreciation deduction on the taxpayer's return. The recapture provisions applicable to §1250 property are fairly complex. An accelerated cost recovery (ACRS) method of depreciation was used for property placed in service on or before December 31, 1986. A modified accelerated cost recovery (MACRS) straight-line system of depreciation was used after 1986. For §1250 property, any depreciation taken under ACRS in excess of the depreciation that would be allowed under a MACRS straight-line cost recovery method is taxed as ordinary income and any gain attributable to unrecaptured depreciation under the MACRS schedule (unrecaptured §1250 gain) is currently taxed at 25%.

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. In addition (as described below), a cost segregation study may result in portions of a building be reclassified as §1245 property **for depreciation purposes**. 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.

Cost Segregation: Some owners of large real estate properties utilize a "cost segregation" study as a means of maximizing the benefits of both real property straight-line depreciation and personal property accelerated depreciation. A cost segregation is a detailed engineering study that reallocates certain components of §1250 (real) property to §1245 (personal) property for depreciation purposes. The goal of cost segregation is to carve out fixtures, HVAC systems and other elements of personal property that have been incorporated into the building, and treat them as separate from the real estate so that the taxpayer may take advantage of the more generous accelerated depreciation schedules available for personal property. 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, otherwise boot will be recognized. For example, if a cost segregated shopping center were exchanged for vacant land, there would be no depreciable personal property in the Replacement Property to offset the §1245 depreciation taken over the life of the Relinquished Property shopping center, and recapture would still be required despite the exchange meeting all other requirements for a full Section 1031 deferral of gain.

Step in the Shoes: In 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 more favorable accelerated depreciation method than the Relinquished Property it replaced. Treasury Regulation §1.168(i)-6T requires that the portion of basis in the new Replacement Property representing exchanged basis (not basis from additional cash) 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 Relinquished Property utilizing the depreciation method of the **Replacement** Property if it has a longer recovery period or a less accelerated depreciation method. In summary, the IRS wins both ways. Pre-existing basis of 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 least advantageous to the taxpayer.

IPX1031

888.771.1031
info@ipx1031.com | www.ipx1031.com

© 2022 Investment Property Exchange Services, Inc.