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 §1250 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%.

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(continued)

Example:

Facts: Taxpayer disposes of a construction crane (§1245 property) with an adjusted basis of $5,000 for a fair market value of $75,000. 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 a total gain of $70,000 ($75,000 - $5,000). Of that gain, $45,000 will be taxed as ordinary income to the taxpayer; the remaining $25,000 will be taxed as a capital gain at 15%.

ii) If the Taxpayer were to dispose of the crane in a §1031 exchange transaction for another crane with a value of at least $75,000 no gain will 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 $60,000 then a $10,000 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.

In addition to depreciation recapture, another important depreciation concept relates to the proper method of depreciation for property acquired in a §1031 exchange. Effective January 3, 2000 the IRS issued a notice revising how depreciation should be calculated for all MACRS replacement property acquired in an exchange. This new method – sometimes referred to as "step in the shoes" depreciation - changed the way most Exchangers depreciate their replacement property. Under Notice 2000-4 (2000-1 CB 313) MACRS property acquired in an exchange should be treated in the same manner as the exchanged MACRS property. Accordingly, the replacement MACRS property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of the exchanged relinquished MACRS property. In addition, any excess of the basis in the acquired MACRS property over the adjusted basis in the exchanged MACRS property is depreciated as newly purchased MACRS property.

Notice 2000-4, in effect, requires the Exchanger to track depreciation on two properties: i) the old MACRS property, which continues to be depreciated as if the exchange never took place, and ii) a new MACRS property consisting of the excess of the Exchanger's basis in the newly acquired property over the adjusted basis in the exchanged property. This excess basis is depreciated as if it were a newly acquired property using the applicable depreciation method, period and convention for that type of property. This "step in the shoes" doctrine has increased the complexity of calculating depreciation on replacement properties. In an exchange of MACRS property and because Exchangers must continue to depreciate the carry over basis from the relinquished MACRS property, Exchangers now may have multiple depreciation calculations associated with a single asset that was acquired as a result of one or more exchanges.

Depreciation issues are 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 with their legal and tax advisors.

[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.

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