Calculating Depreciation Recapture Under IRC 1245 and 1250: Minimizing Tax Through Transaction Planning

TUESDAY, AUGUST 15, 2017, 1:00-2:50 pm Eastern

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Calculating Depreciation Recapture Under IRC 1245 and 1250

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DEPRECIATION RECAPTURE

§1245 and §1250

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What is Depreciation Recapture?
example A: “break-even” resale
What is Depreciation Recapture?
example B: profitable resale

- Initial basis = $100k
  - Adjusted basis: $70k
- Depreciation: $30k
- Taxable Gain: $50k
- Appreciation: Depreciation recapture
- Sales price = $120k
What is Depreciation Recapture?
example C: unprofitable resale

- Initial basis = $100k
  - Depreciation $30k
  - Adjusted basis $70k

- Taxable Gain $20k

- Depreciation recapture
  - Sales price = $90k
What is Depreciation Recapture?
example D: resale after Sec. 179

Initial basis = $100k
100% depreciated under Section 179
Adjusted basis = $0

Taxable Gain $30k
Depreciation recapture
Sales price = $30k
What is Depreciation Recapture?

• Depreciation is not a freebie – it is a loan
• Taxable gain from profitable disposition consists of two parts:
  increase in value of the asset (appreciation & inflation) and
  reversal of prior depreciation deductions (recapture)
• Because of depreciation recapture, taxable gain is possible even from unprofitable disposition!
What is Depreciation Recapture?

• Depreciation recapture triggers unexpected extra taxes, often to clients’ shock

• Depreciation recapture is taxed very differently for two types of assets:
  - Section 1250 assets – most real property
  - Section 1245 assets – most other business assets

• Whenever there is complexity – there are tax planning opportunities! (and CPA job security)
Background

- Historically, treatment of depreciable property, created a mismatch because depreciation could be deducted from ordinary income, but gains were taxed as capital gains.
- Example: a taxpayer takes $30k of depreciation deductions on property, and later sells the property for a gain of $30k. Today, the depreciation deductions would be worth $11,880, based on the top marginal ordinary rate of 39.6%. Without recapture, the tax on the resulting gain would only be $6k, based on the capital gains rate of 20%. This results in a $5,880 tax benefit to the taxpayer.
• §1245 and §1250 were enacted to fix this mismatch by taxing the part of the gain attributable to depreciation at ordinary rates. This corrective recharacterization is known as “recapture”

• Subsequent legislation reduced the importance of recapture rules
  • For example, corporations no longer face different rates for capital gains and ordinary income, eliminating the need for recapture

• However, the rules are still important for individuals, S Corps., partnerships, etc.
What is Depreciation Recapture?

• The recapture rules are essentially asking a question: how much gain is attributable to depreciation deductions?

• Example: a taxpayer buys depreciable property for $50k. Taxpayer’s basis starts at $50k, but depreciation deductions decrease this basis to $40k. Later, taxpayer sells the property for $60k, resulting in a gain of $20k. Only $10k of this gain is attributable to depreciation deductions so recapture only applies to that $10k of gain.
§1245 Property

• All personal property

• Certain types of real property
  • Investment credit property – tangible real property, other than a building and its structural components, used as an “integral part” of or in connection with certain specified activities
  • Other specific real property
    • For example, §179 property, pollution control facilities (§169), architectural and transportation barrier removals (§190), etc.
§1245 Property - “Integral Part” Test

- The “Integral Part” test looks at whether property is
  - (1) used directly in one of the specified activities; and
  - (2) essential to the completeness of the activity
- Specified activities include manufacturing, production, extraction, and providing transportation, communications, electrical energy, gas, water, and sewage disposal services
  - For example, fences used to confine livestock on a farm, a sewer system used by a natural gas transmission company, and fire-safety walls used at an oil refinery
§1250 Property

- All real property that is not §1245 property
  - For example, apartment buildings, factories, stores, sports stadiums, and aircraft hangers
Why Two Sections?

• Two sections arose because Congress believed gain was attributable to different things in different types of property

• For §1245, which covers all personal property and some real property, and the assumption was that gain only resulted from depreciation deductions, not an increase in fair market value; without the deductions, personal property would simply decrease in value and be sold at a loss

• Thus, §1245 is an objective rule that does not allow taxpayers to prove that gain is from an increase in value
Why Two Sections? (cont’d)

• §1245 can be unfavorable to taxpayers:
  • Example: taxpayer buys a car for $30k, takes $10k of deductions, and sells the car for $32k twenty years later. The $12k of gain is the cap on recapture, so the full $10k of deductions can be recaptured. However, $32k in twenty years may only be worth $25k at the time the car was purchased. If the taxpayer had sold the car for $25k then recapture would be limited to $5k, but the taxpayer is not allowed to prove this
Why Two Sections? (cont’d)

• For §1250, which covers many types of real property, the assumption was that this property is held for a long time, so gain was attributable to inflation. Thus, recapture only applies to depreciation deductions taken in excess of the actual wear and tear, assuming the real property was held for more than one year.

• Note: the amount of deductions under the straight-line method is used as a substitute for the actual wear and tear.
Why Two Sections? (cont’d)

• §1250 can be favorable to taxpayers:
  • Example: A taxpayer buys an apartment building in a city for $500k and takes straight-line depreciation deductions totaling $250k. The city becomes a popular place to live and taxpayer sells the apartment building for $750k. By applying the logic underlying §1250, there would be no recapture on such property even though some gains are clearly attributable to a rise in demand (not just inflation).
  • Note: The Taxpayer Relief Act of 1997 resolves this by imposing a 25% tax on unrecaptured §1250 gain.
Why Two Sections? - Summary

• To generalize, if you had a factory that made t-shirts, the machinery that makes the shirts would likely be §1245 property, and the physical building would likely be §1250 property.

• Although the machinery might be a fixture in the factory, it depreciates in value much like traditional §1245 personal property (cars, computers, etc.).

• The factory building itself will last a long time, and the unique application of §1250 is meant to accommodate for the role of inflation on this type of property.
Triggering §1245 and §1250

• Recapture occurs upon any disposition of applicable property
  • Examples: sale, involuntary conversion without replacing the property, foreclosure, a gift of property with a mortgage in excess of its adjusted basis, some sale leasebacks, etc.
When §1245 and §1250 Do Not Apply

• Transfers at death: stepped-up basis prevents recapture

• Principal residence: despite the exclusion from taxation under §121, gains from the sale of a principal residence are subject to §1250 recapture where the residence is also used in a trade or business, and where the residence was formerly used as a trade or business

• Recapture is determined by taking the amount of §1250 recapture if the disposition were fully taxable, and multiplying it by the following fraction:

\[
\frac{\text{fair market value of business portion}}{\text{fair market value of whole property}}
\]
When §1245 and §1250 Do Not Apply (cont’d)

• A sale of stock does not trigger recapture
  • This should be kept in mind when determining purchase price
  • A §338 election or §336(e) election can be used to trigger gain, and thus recapture
  • If stock is sold then the buyer will have to face the burden of recapture on a future sale
When §1245 and §1250 Do Not Apply (cont’d)

• Tax-Free Carryovers: where a transferor’s basis is shifted over to the transferee
  • For example, dispositions by gift, distributions in complete liquidation of 80%+ controlled subsidiaries (§332), transfers to a corporation (§351), corporate reorganizations (§361), transfers to a partnership in exchange for partnership interest (§721), and distributions by a partnership to a partner (§731)
  • Gain is recaptured to the extent it is recognized under applicable Code provisions
When §1245 and §1250 Do Not Apply (cont’d)

• Tax-Free Rollovers: where a property’s adjusted basis is transferred to replacement property
  • For example, like-kind exchanges (§1031) and involuntary conversions with acquisition of replacement property (§1033)
  • Gain is recaptured to the extent of “boot”
Determining the Amount of Recapture

- For §1245, the amount of gain treated as ordinary income is the lower of:
  - The Gain Limitation; or
  - The Depreciation Limitation

- For §1250, the amount of gain treated as ordinary income is the “applicable percentage” multiplied by the lower of:
  - The Gain Limitation; or
  - The Depreciation Limitation
The Gain Limitation

• The gain limitation equals the gain realized or the potential gain
  • Gain Realized = amount realized – adjusted basis
  • Potential Gain = fair market value – adjusted basis

• Examples:
  • Gain Realized: taxpayer sells property for $300 and the property had an adjusted basis of $200. The gain realized is $100 (amount realized – adjusted basis)
  • Potential Gain: a corporation owns property with an adjusted basis of $700 and a fair market value of $1,200. If the corporation distributes the property as a dividend to its shareholders, the potential gain will be $500 (fair market value – adjusted basis)
The Depreciation Limitation

• For §1245 property and §1250 property held for less than one year, the depreciation limitation is the amount of depreciation or amortization actually taken

• For §1250 property held for more than one year, the depreciation limitation is the amount of depreciation taken in excess of the amount allowable under the straight-line method
  • Most real property is now required to use the straight-line method of depreciation
Applicable Percentage

• For §1250, the gain limitation and depreciation limitation are multiplied by the “applicable percentage”

• For property acquired after 1975, the applicable percentage is 100%. Where §1250 property was acquired before this date there may be a decrease of 1% for every month the property is held after a certain number of months

• Currently, there are some types of property that can qualify for a lower applicable percentage
  • For example, the applicable percentage for low-income dwelling units and Title V loan property decreases by 1% every month after an initial period of 100 months
Depr. Recap. for Section 1250

Source of major confusion: there are TWO completely different depreciation recapture rules for Section 1250 real property:

1. Recapture per Sec. 1250 and Regs. 1.1250

2. Unrecaptured 1250 gain per TRA-97
Codified Sec. 1250 recapture

• Depreciation taken over and above straight-line method is recaptured at ordinary rates, just like the entire Sec. 1245 recapture.

• For pre-1987 real property depreciation, this is a relatively small portion of the total depreciation taken.

• All post-1986 real property depreciation is straight-line, so this recapture is ZERO.
…which makes you think that…

• Since lately there is straight-line depreciation only, there is no recapture, meaning there is no ordinary rate taxation, and all gain (including the depreciation portion of it) can enjoy long-term capital gains rates – 15% (20% for high-income)?

• Would not it be nice? Depreciation is deducted at ordinary 25%-33%-39.6% rate and eventually recaptured at 15%-20%?
Unrecaptured Sec. 1250 gain

• Introduced by the Taxpayer Relief Act of 1997, aka Public Law 105-34

• Makes all Section 1250 gain up to the depreciation (as always, “allowed or allowable”) taxed at the ordinary rates, up to 25%.

• This is a mid-way compromise: worse than LTCG, but still better than Section 1245.
Taxation of Section 1250 gains

- Initial basis = $100k
  - Depreciation $30k
  - Adjusted basis $70k
  - Taxable Gain $50k
  - Appreciation
    - Unrecaptured Section 1250 gain
  - Sales price = $120k
Taxation of Section 1250 gains

25% tax bracket. MFJ, AGI $120k before sale

Naïve expectation:
$20,000 gain x 15% LTCG = $3,000 tax

Reality:
$20,000 capital gain x 15% = $3,000
$30,000 unrecaptured 1250 x 25% = $7,500
Total tax: $7,500 + $3,000 = $10,500

Client shock: $7,500
Taxation of Section 1250 gains

25% tax bracket. MFJ, AGI $120k before sale

*Half-educated expectation:*  
$50,000 gain x 15% LTCG = $7,500 tax

*Reality:*  
$30,000 unrecaptured 1250 x 25% = $7,500  
$20,000 capital gain x 15% = $3,000  
Total tax: $7,500 + $3,000 = $10,500

*Client shock:* $3,000
Taxation of Section 1250 gains

15% tax bracket. MFJ, AGI $45k before sale

Naïve/Half-educated expectation:
$20,000 / $50,000 gain x 0% LTCG = $0 tax

Reality:
$30,000 unrecaptured 1250 x 15% = $4,500
$20,000 capital gain x 0% = $0
Total tax: $4,500 + $0 = $4,500

Client shock: $4,500
### Taxation of Section 1250 gains

<table>
<thead>
<tr>
<th>AGI (MFJ)</th>
<th>$45k</th>
<th>$120k</th>
<th>$300k</th>
<th>$500k</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax bracket</td>
<td>15%</td>
<td>25%</td>
<td>33%</td>
<td>39.6%</td>
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</table>

#### Capital gain

<table>
<thead>
<tr>
<th>LT capital gain</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>LTCG rate</td>
<td>0%</td>
<td>15%</td>
<td>15%</td>
<td>20%</td>
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<tr>
<td>LTCG tax</td>
<td>$0</td>
<td>$3,000</td>
<td>$3,427</td>
<td>$4,000</td>
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</table>

#### Recapture

<table>
<thead>
<tr>
<th>Depr. recapture</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
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</thead>
<tbody>
<tr>
<td>Recapture rate</td>
<td>15%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Recapture tax</td>
<td>$4,500</td>
<td>$7,500</td>
<td>$7,928</td>
<td>$7,500</td>
</tr>
</tbody>
</table>

| Total tax | $4,500 | $10,500 | $11,355 | $11,500 |
## Taxation of Sec.1250 vs Sec.1245

<table>
<thead>
<tr>
<th>AGI (MFJ)</th>
<th>Section 1250</th>
<th></th>
<th>Section 1245</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$45k</td>
<td>$120k</td>
<td>$300k</td>
<td>$45k</td>
<td>$120k</td>
<td>$300k</td>
</tr>
<tr>
<td>15%</td>
<td>25%</td>
<td>33%</td>
<td>15%</td>
<td>25%</td>
<td>33%</td>
</tr>
</tbody>
</table>

### Capital gain

<table>
<thead>
<tr>
<th>LT capital gain</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>LTCCG rate</td>
<td>0%</td>
<td>15%</td>
<td>15%</td>
<td>0%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>LTCCG tax</td>
<td>$0</td>
<td>$3,000</td>
<td>$3,427</td>
<td>$0</td>
<td>$3,000</td>
<td>$3,427</td>
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</table>

### Recapture

<table>
<thead>
<tr>
<th>Depr. recapture</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
<th>$30,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recapture rate</td>
<td>15%</td>
<td>25%</td>
<td>25%</td>
<td>15%</td>
<td>25%</td>
<td>33%</td>
</tr>
<tr>
<td>Recapture tax</td>
<td>$4,500</td>
<td>$7,500</td>
<td>$7,928</td>
<td>$4,500</td>
<td>$7,500</td>
<td>$10,328</td>
</tr>
</tbody>
</table>

### Total tax

| Total tax      | $4,500  | $10,500 | $11,355 | $4,500  | $10,500 | $13,755 |
## Taxation of Sec. 1250 vs Sec. 1245

<table>
<thead>
<tr>
<th>AGI (MFJ)</th>
<th>Section 1250</th>
<th>Section 1245</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax bracket</td>
<td>$45k $120k $300k</td>
<td>$45k $120k $300k</td>
</tr>
<tr>
<td>15%</td>
<td>25%</td>
<td>33%</td>
</tr>
</tbody>
</table>

### Capital gain
- **LT capital gain**: $20,000 $20,000 $20,000
- **LTCG rate**: 0% 15% 15%
- **LTCG tax**: $0 $3,000 $3,427

### Recapture
- **Depr. recapture**: $30,000 $30,000 $30,000
- **Recapture rate**: 15% 25% 25%
- **Recapture tax**: $4,500 $7,500 $7,928

**This was not total!**
- **Total for Section 1250**: $4,500 $10,500 $11,355
- **Total for Section 1245**: $4,500 $10,500 $13,755

- **NIIT (3.8%)**: $0 $0 $1,900
- **AMT**: $0 $0 $1,694

**Now, the real total:**
- **Section 1250**: $4,500 $10,500 $14,949
- **Section 1245**: $4,500 $10,500 $15,849
Fair Market Value Allocation Rule

• It is common for a disposition of property to include a combination of §1245 property, §1250 property, and nondepreciable property

• Fair Market Value Allocation Rule: the amount realized must be proportionally allocated to each class of property relative to the fair market values of such property
• Allocations made by adverse parties in an arm’s length transaction are generally respected.

• Where this is no prior allocation, some facts that establish the fair market value are: (i) the original cost of construction, erection, or production, (ii) the remaining economic useful life, (iii) state of obsolescence, and (iv) the anticipated expenditures to maintain, renovate, or modernize.
Fair Market Value Allocation Rule – Application

Example: a business is sold for $1 million:

<table>
<thead>
<tr>
<th></th>
<th>§1245</th>
<th>§1250</th>
<th>Land</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value</td>
<td>$360k</td>
<td>$720k</td>
<td>$120k</td>
<td>$1.2 million</td>
</tr>
<tr>
<td>% of Fair Market Value</td>
<td>30%</td>
<td>60%</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocation of Purchase Price</td>
<td>$300k</td>
<td>$600k</td>
<td>$100k</td>
<td>$1 million</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$270k</td>
<td>$550k</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain Limitation</td>
<td>$30k*</td>
<td>$50k</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation Limitation</td>
<td>$120k</td>
<td>$20k*</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Amount Recaptured
Fair Market Value Allocation Rule – Potential Problem

• Where a property is sold for its adjusted basis, the Fair Market Value Allocation Rule can be detrimental
  • If property is sold for its adjusted basis there should no recapture (the Gain Limitation would be $0), but the Fair Market Value Allocation Rule may result in an allocation that triggers recapture
  • This problem might arise in the case of a bargain sale
Fair Market Value Allocation Rule – Potential Problem

- Example: a mother sells her son a factory for an amount equal to the total adjusted basis:

<table>
<thead>
<tr>
<th></th>
<th>§1245</th>
<th>§1250</th>
<th>Land</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value</td>
<td>$70k</td>
<td>$90k</td>
<td>$40k</td>
<td>$200k</td>
</tr>
<tr>
<td>% of Fair Market Value</td>
<td>35%</td>
<td>45%</td>
<td>20%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocation of Purchase Price</td>
<td>$35k</td>
<td>$45k</td>
<td>$20k</td>
<td>$100k</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$30k</td>
<td>$40k</td>
<td>$30k</td>
<td>$100k</td>
</tr>
<tr>
<td>Gain Limitation</td>
<td>$5k*</td>
<td>$5k*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation Limitation</td>
<td>$20k</td>
<td>$30k</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Amount Recaptured
Fair Market Value Allocation Rule – Potential Problem

• The mother will recognize some recapture under §1245 and §1250

• However, if each type of property had been sold individually for its adjusted basis, there would have been no recapture
Tax-Free Carryover Boot Allocation Rule

- In various tax-free carryovers, such as §721 transfers to partnerships and §351 transfers to controlled corporations, the transaction is tax-free except to the extent of “boot” received.
- Any “boot” is allocated to each class of property proportionally to the fair market value of each class.
# Tax-Free Carryover Boot Allocation Rule - Application

Example: In a §351 transaction, $160k of stock and $40k of boot are exchanged for the following:

<table>
<thead>
<tr>
<th></th>
<th>§1245</th>
<th>§1250</th>
<th>Land</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value</td>
<td>$80k</td>
<td>$100k</td>
<td>$20k</td>
<td>$200k</td>
</tr>
<tr>
<td>% of Fair Market Value</td>
<td>40%</td>
<td>50%</td>
<td>10%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocation of Purchase Price [Total (stock + boot)]</td>
<td>$80k ($64k + $16k)</td>
<td>$100k ($80k + $20k)</td>
<td>$20k ($16k + $4k)</td>
<td>$200k ($160k + $40k)</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$60k</td>
<td>$70k</td>
<td>$80k</td>
<td>$210k</td>
</tr>
<tr>
<td>Gain Limitation</td>
<td>$20k*</td>
<td>$30k</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation Limitation</td>
<td>$25k</td>
<td>$15k*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recaptured Amount</td>
<td>$16k</td>
<td>$15k</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Recaptured to the extent of boot
Tax-Free Rollover Replacement Allocation Rule

• This rule compares classes of replacement property with classes of disposed property

• In like-kind exchanges and involuntary conversions, the Fair Market Value Allocation Rule is used to determine the amount realized

• The amount realized is deemed to consist of as much fair market value of replacement property of the same class not in excess of the amount realized

• The remaining amount realized can be deemed to consist of the fair market value of other property acquired, not in excess of such remaining portion
## Tax-Free Rollover Replacement Allocation Rule – No Replacement

- **Example:** A taxpayer receives insurance proceeds of $200k due to the destruction of the following property:

<table>
<thead>
<tr>
<th></th>
<th>§1245</th>
<th>§1250</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair Market Value</td>
<td>$80k</td>
<td>$120k</td>
<td>$200k</td>
</tr>
<tr>
<td>% of Fair Market Value</td>
<td>40%</td>
<td>60%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocation of Proceeds/Amount Realized</td>
<td>$80k</td>
<td>$120k</td>
<td>$200k</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>$10k</td>
<td>$20k</td>
<td></td>
</tr>
<tr>
<td>Gain Limitation</td>
<td>$70k*</td>
<td>$100k*</td>
<td></td>
</tr>
<tr>
<td>Depreciation Limitation</td>
<td>$100k</td>
<td>$110k</td>
<td></td>
</tr>
</tbody>
</table>

* Recaptured unless replacement property is acquired under §1033
Tax-Free Rollover Replacement Allocation Rule - Replacement

• Example: Taxpayer uses insurance proceeds to replace the property under §1033:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Allocation of Proceeds/Amount Realized</th>
<th>Cost of Replacement</th>
<th>Remaining Amount Realized</th>
<th>Extra Amount Invested</th>
</tr>
</thead>
<tbody>
<tr>
<td>§1245</td>
<td>$10k</td>
<td>$80k</td>
<td>$110k</td>
<td>n/a</td>
<td>$30k</td>
</tr>
<tr>
<td>§1250</td>
<td>$20k</td>
<td>$120k</td>
<td>$90k</td>
<td>$30k</td>
<td>n/a</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$200k</td>
<td>$200k</td>
<td>$30k</td>
<td>$30k</td>
</tr>
</tbody>
</table>

• No recapture as a result of the replacement allocation rule.
Tax-Free Rollover Replacement Allocation Rule – Multiple Classes of Property

- Multiple classes of property are trickier but provide an opportunity for tax planning
- The taxpayer decides how to allocate the excess value of replacement property
  - The overall amount of taxes can vary based on how the taxpayer chooses this allocation
Tax-Free Rollover Replacement Allocation Rule – Multiple Classes of Property (cont’d)

- Example: In a like-kind exchange, a taxpayer exchanges Property A for Property B:

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value (Property A)</th>
<th>Fair Market Value (Property B)</th>
<th>Remaining Amount Realized</th>
<th>Extra Amount Invested</th>
</tr>
</thead>
<tbody>
<tr>
<td>§1245</td>
<td>$15k</td>
<td>$35k</td>
<td>$55k</td>
<td></td>
<td>$20k</td>
</tr>
<tr>
<td>§1250</td>
<td>$0</td>
<td>$45k</td>
<td>$28k</td>
<td>$17k</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$3k</td>
<td>$20k</td>
<td>$12k</td>
<td>$8K</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$5k</td>
<td></td>
<td></td>
<td>$5k</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$100k</td>
<td>$100k</td>
<td>$25k</td>
<td>$25k</td>
</tr>
</tbody>
</table>

Potential §1250 Recapture = $17k
Option 1 [BAD]:
- $8k of §1245 property is allocated to the Land, the remaining $12k is allocated to §1250 property
- Result: $5k of §1250 property is recaptured (note: this is limited to the value of boot where applicable). No gain recognized on Land

Option 2 [GOOD]:
- $17k of §1245 property is allocated to §1250 property, the remaining $3k is allocated to Land. $5k of Cash is allocated to Land
- Result: $2k of gain on Land is taxed. ($5 boot - $3 adjusted basis). No recapture on §1245 and §1250 property
Installment Sales

• Prior to June 6, 1984, recapture was possible on the installment method
  • Payments were allocated to recapture first, but only to the extent of gain
• Now, recapture occurs entirely in the year of the installment sale
  • It does not matter if no payments are made in the year of the sale
• The amount of recapture in the year of the sale is added to the basis of the property
• Excess gain over the recaptured amount is reportable on the installment method
Installment Sales – Application of Former Rule

- Example: A taxpayer sells §1245 property for $600k, payable in five equal, annual payments starting in the second year after the sale. At the time of the sale, the property had an adjusted basis of $100k and a depreciation limitation of $250k.

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment</td>
<td>$0</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$600k</td>
</tr>
<tr>
<td>Basis</td>
<td>$0</td>
<td>$20k</td>
<td>$20k</td>
<td>$20k</td>
<td>$20k</td>
<td>$20k</td>
<td>$100k</td>
</tr>
<tr>
<td>Gain</td>
<td>$0</td>
<td>$100k</td>
<td>$100k</td>
<td>$100k</td>
<td>$100k</td>
<td>$100k</td>
<td>$500k</td>
</tr>
<tr>
<td>Recapture</td>
<td>$0</td>
<td>$100k</td>
<td>$100k</td>
<td>$50k</td>
<td>$0</td>
<td>$0</td>
<td>$250k</td>
</tr>
<tr>
<td>Remaining Gain</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$50k</td>
<td>$100k</td>
<td>$100k</td>
<td>$250k</td>
</tr>
</tbody>
</table>
### Installment Sales – Application of Current Rule

- **Example:** A taxpayer sells §1245 property for $600k, payable in five equal, annual payments starting in the second year after the sale. At the time of the sale, the property had an adjusted basis of $100k and a depreciation limitation of $250k.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Year 6</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payment</td>
<td>$0</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$120k</td>
<td>$600k</td>
</tr>
<tr>
<td>Basis</td>
<td>$0</td>
<td>$70k</td>
<td>$70k</td>
<td>$70k</td>
<td>$70k</td>
<td>$70k</td>
<td>$350k</td>
</tr>
<tr>
<td>Gain</td>
<td>$0</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$250k</td>
</tr>
<tr>
<td>Recapture</td>
<td>$250k</td>
<td>$0k</td>
<td>$0k</td>
<td>$0k</td>
<td>$0</td>
<td>$0</td>
<td>$250k</td>
</tr>
<tr>
<td>Remaining Gain</td>
<td>$0</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$50k</td>
<td>$250k</td>
</tr>
</tbody>
</table>
Installment Sales - Planning

• Note: if the entire gain is subject to recapture then the installment method is not possible

• Planning options:
  • Sell a property in several fractional interests. However, make sure that sales are spread far enough apart, and appear substantive enough, to avoid recharacterization by the IRS
  • In the year of sale, have the buyer pay at least an amount to cover the recapture tax liability. This can also be structured as a down payment
  • Consider a tax-free exchange
  • Lease with an option to purchase
Section 1250 tax planning

1. Timing of sale
2. Land allocation
3. Section 1245/1250 allocation
4. Installment sales
5. Like-kind (Sec. 1031) exchanges
Section 1250 tax planning

Timing of sale – A: fluctuating AGI

Everything else being equal (is it ever ?), try to sell in the year with low AGI. Reasons: tax bracket, LTCG, NIIT, AMT

High rates of depreciation recapture tax make this consideration more important than 15% LTCG.
Section 1250 tax planning

Timing of sale – B: ordinary v. capital gain netting

Depreciation recapture on Section 1245 is treated as ordinary income. In contrast, 25% unrecaptured 1250 gain is considered capital gain income.

While the rates and resulting taxes can be the same, only capital gain income can offset capital losses.

Why would that matter?
Because of $3,000/yr limit on capital losses
Section 1250 tax planning

Timing of sale – B: ordinary v. capital gain netting

Using numbers from our earlier example ($100k purchase - $120k sale - $30k depreciation):
  Sec. 1245 property would have $20k available to absorb capital losses, while
  Sec. 1250 property would have $50k available for an offset.

• Do you have incoming carry-forward capital losses?
  If yes, then maybe extra taxes will be absorbed

• Do you have assets that need to be sold at a loss?
  If yes, then do not wait until the next tax year!
Section 1250 tax planning

Timing of sale – C: Passive Activity Losses

Passive activity losses (PAL) could be suspended under Section 469. Two common sources of PAL:

- rental (Schedule E) properties
- K-1s without material participation

Suspended PAL losses from prior years are carried forward, so the client might have a reserve.

Do you have current or carry-forward PALs?  
If yes – they could be netted against gains!
Section 1250 tax planning

Timing of sale – D: unlocked PALs

PALs previously suspended due to high AGI, are released when the property is disposed – regardless of the AGI.

Suddenly, the taxpayer has Sch. E losses, possibly significant, that were not available in the past.

It can wildly swing the overall tax situation. Make sure to consider the impact.
Section 1250 tax planning

Land allocation

Purchased $200k house; 25% allocated to land
  $50k land; $150k building (27.5-yr asset).
  $50k depreciation
Sold for $300k => $150k gain

Standard calculation of tax:
  $50k depr. recapture x 25% = $12,500
  $100k cap. gain x 15% = $15,000
Total tax: $27,500
Section 1250 tax planning

Land allocation

But what if the appreciation of the property is due to the increase in land value, and the current value allocation is 2/3 land ($200k) and 1/3 building ($100k)?

Revised calculation of tax:

$0 gain on the building => $0 depr. recapture
$150k cap. gain (land) x 15% = $22,500

Tax savings: $27,500 - $22,500 = $5,000
Section 1250 tax planning

Section 1245/1250 allocation

If the property consists of both 1245 and 1250 assets, allocation matters.

- Gain on Sec. 1245 property is taxed higher for those above the 25% bracket.
- Depreciation recapture on Sec. 1245 property cannot offset capital losses.
- It also matters for like-kind exchanges.
Section 1250 tax planning

**Installment sales** (aka owner-financing)

You receive down payment + regular payments consisting of principal and interest.

Under Section 453, with installment sale treatment, part of the down payment and each principal payment is considered return of the basis, and part is taxed as gain.

**Economic advantages:**
- above-market interest rate
- often higher sales price
- regular income stream
- payments are secured (sort of) by the property
Section 1250 tax planning

Installment sales (continued)

Tax advantages:
- time value of money, as gains are deferred
- usually lowers AGI in each year
- unrecaptured 1250 gains are part of the deal!

Risks:
- future payments are at risk
- foreclosing is a hassle, and property value can drop
- may push some gain into a high-AGI future year

Warning: all unrecaptured 1250 gain (25%) is counted before any of the capital gain (15%).
Section 1250 tax planning

Like-kind (Section 1031) exchanges

**Concept:** deferring capital gain. Gain is not recognized at the time of disposition and instead is rolled into the replacement property.

**Great news:** unrecaptured 1250 gain included!

**Warning:** for Sec. 1250 real property, this is a highly complicated transaction with lots of conditions and traps.
Section 1250 tax planning

Like-kind (Section 1031) exchanges – complications

- Before considering an exchange, run the numbers: is your expected tax high enough to justify the hassle and cost?

- Don’t let the tax considerations override the business consideration. The deal has to make business sense first! Would you invest into this deal if not for an exchange?

- Concept: trading up, both in property value and in mortgage debt. In other words, you will be buying a bigger property (or multiple properties) with higher debt.

- Any cash that you pull out of the exchange will be a taxable “boot” – defeating the point of entering into an exchange.
Section 1250 tax planning

Like-kind (Section 1031) exchanges - complications

- Use a reputable “qualified intermediary” (Warning: your money is not protected in their hands, no FDIC!)
- Exchange must be initiated before the sale of the property. If you already sold the property, game over.
- There’re firm deadlines to find and close on replacement property(-ies). Ideally, you should line up your next investment before you start the exchange process.
- Hire a tax expert specializing in real estate. Exchange calculations are crazy complex. Mistakes are very costly.