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

TUESDAY, AUGUST 27, 2019, 1:00-2:50 pm Eastern

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

August 27, 2019

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DEPRECIATION RECAPTURE
§1245 and §1250

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## Agenda

- Review Depreciation Concepts
- Introduce the Concepts of Depreciation Recapture
- Triggering Recapture - When it Does and Does Not Apply
- Mechanics of the Calculation
- Cost Segregation, 1031 Exchange and Depreciation Recapture
- Planning Considerations
Depreciation refers to slowly expensing the cost of capitalized assets in a systematic manner.
MACRS – 2 Systems

General Depreciation System; §168(a)

Default convention

Alternative Depreciation System; §168(g)

Mandatory for assets:

- Used outside of the US
- Certain property leased to tax-exempt entities
- Property financed with tax exempt bonds
- With recent tax reform; taxpayers may be required to use ADS if they have elected out of the interest limitation
MACRS Property Classes

- 3-, 5-, 7-, 10-, 15-, and 20-year property
- 27.5-year residential rental property
- 39-year nonresidential real property
Depreciation recapture is an income tax rule in which a gain on the sale of property is treated as ordinary income, or partly as ordinary income, to the extent that accelerated depreciation was taken on the property.
For businesses assets - depreciation comes into play

Depreciation is a deduction intended to match benefit with expense

The concept would be; when an asset is fully depreciated it is “used up” (its usefulness matches the expense throughout the asset’s lifetime)

Consider that the preferential 1231 Long Term capital gain rate of 20% was put in place to encourage investment
When businesses who were allowed depreciation deductions sell an asset at an appreciated price, they are benefiting from the rate difference of these two tax directives.

Essentially the recapture rules keep taxpayers from saving tax dollars by disallowing the preferential gain rate on the depreciated portion of the gain.
What is depreciation recapture?

When an asset is sold at a value above the adjusted basis, the gain is taxed as ordinary income up to the amount of depreciation claimed to the extent of the excess of accelerated depreciation that would have been allowed.

This ordinary income treatment is referred to as depreciation recapture.
What is depreciation recapture? (said another way)

- The recapture rules are essentially asking a question: How much of the gain on sale is attributable to depreciation deductions?

- More specifically, how much gain is attributable to **accelerated** depreciation deductions?
Basic Example

You purchase a red wagon in 2018 for $500. You take your bonus deduction for the entire amount. This gives you a reduction of ordinary income in the amount of $500 and tax savings equal to $185. (37% tax rate x $500)

One year and one day later, you sell this for $500 – the same price you initially paid. Capital gain tax is only $100. (20% of the gain)

You saved 20% on taxes automatically!

- The IRS needed to keep this scenario from happening!
Now Consider a Larger Asset

- Assume you build a 10 million dollar building and completed a cost segregation study. With bonus and accelerated depreciation, you were able to take 3 million in depreciation deductions in the first three years saving 1.11 million in tax at a 37% rate.

- You sell the building after year 3 for 10 million. The capital gain would only be 600K, saving the building owner 600K in tax.

- Allowing this sort of benefit was not the intention of the IRS, so they introduced depreciation recapture.
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 Recapture is not Triggered

- Step Up in basis at death
- Tax-Free Rollovers: (when a property’s adjusted basis is transferred to replacement property)

Examples:
1. Like-kind exchanges ($1031)
2. Involuntary conversions with acquisition of replacement property ($1033)
3. Gifts, etc.
Tangible Property Regulations

- Recapture only applies to items that are capitalized and depreciated.
- Expensing repairs will keep them from potential future recapture.
Personal Property

Code Sec. 1245 personal property (Code Sec. 1245(a)(3)(A)), which consists of items such as business machinery and equipment, office furniture and fixtures, and appliances that are furnished to tenants. The principal characteristic of Code Sec. 1245 personal property is that it is readily moveable rather than permanently affixed.
Personal Property and 1031 Exchange

Code Sec. 1245 personal property is a federal tax depreciation concept.

Property can be considered Section 1245 personal property for federal income tax purposes and still be considered real property for state law purposes (for 1031 purposes).
All depreciation taken on these assets (up to the amount of the gain on sale) is recaptured at ordinary income rates.
Real Property

Code Sec. 1250 real property, such as a building or a structural component of a building, and most land improvements.

- Residential rental property that is depreciated over 27.5 years using the straight line method.
- Nonresidential real property that is depreciated over 39 years using the straight line method.
Basic Rules of Depreciation Recapture

- Applies to depreciation when the sale proceeds exceed the adjusted basis or net book value
  - When proceeds exceed the adjusted basis of an asset, the difference will first be allocated to previous depreciation deducted (the recapture portion) and then to capital gain
- §1245 and §1250 property are not treated the same in recapture
  - In the case of §1250 property, only accelerated depreciation taken in excess of straight-line depreciation is considered (ie for land improvements)
  - All accelerated depreciation, §1245 or §1250, is recaptured at ordinary rates, currently 37% for individuals
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 over the amount allowable under the straight-line method.
  - Most real property with a class life of 27.5 or 39 years is required to use the straight-line method.
Review of Income Tax Rates

- Top Individual Rate: 37%
- Top Corporate Rate: 21%

- LT Capital Gain Rates:
  - 20% for individuals
  - 21% for corporations
Mechanics
Sec. 1245 Depreciation Recapture

- Initial basis = $100k
  - 100% depreciated
  - under Section 179
- Adjusted basis = $0
- Taxable Gain $30k
- Depreciation recapture
- Sales price = $30k
Sec. 1250 Depreciation Recapture

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.
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 22%-37% 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
Shocked clients – Ex. 1

22% 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 22% = $6,600
Total tax: $6,600 + $3,000 = $9,600

Client shock: $6,600
Taxation of Section 1250 gains

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

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Shocked clients – Ex. 2

22% 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 22% = $6,600
$20,000 capital gain x 15% = $3,000

Total tax: $6,600 + $3,000 = $9,600

**Client shock:** $2,100
Shocked clients – Ex. 3

12% 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 12% = $3,600
$20,000 capital gain x 0% = $0

Total tax: $3,600 + $0 = $3,600

Client shock: $3,600
# Taxation of Section 1250 gains

<table>
<thead>
<tr>
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<th>$45k</th>
<th>$120k</th>
<th>$350k</th>
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<tr>
<td>Tax bracket</td>
<td>12%</td>
<td>22%</td>
<td>32%</td>
<td>35%</td>
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**Capital gain**

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<tr>
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<tr>
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<td>15%</td>
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**Recapture**

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<td>Recapture tax</td>
<td>$3,600</td>
<td>$6,600</td>
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</table>

**Total tax**

| $3,600 | $9,600 | $10,500 | $11,500 |
## Taxation of Sec. 1250 v. Sec. 1245

<table>
<thead>
<tr>
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<th>Section 1245</th>
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<td><strong>Recapture</strong></td>
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<td><strong>Total tax</strong></td>
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### Notes
- Capital gains tax rates:
  - Section 1250: 0%, 15%, 15%
  - Section 1245: 0%, 15%, 15%
- Recapture rates:
  - Section 1250: 12%, 22%, 25%
  - Section 1245: 12%, 22%, 32%
- Total tax:
  - Section 1250: $3,600, $9,600, $10,500
  - Section 1245: $3,600, $9,600, $12,600
## Taxation of Sec. 1250 v. Sec. 1245

<table>
<thead>
<tr>
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<th>Section 1245 - <strong>NON-PASSIVE</strong></th>
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<td>$12,600</td>
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Cost Segregation, 1031 Exchange, and Depreciation Recapture
What is a cost segregation study?

- Real estate assets are frequently capitalized and depreciated as one building with one class life - §1250

- Cost Segregation uses a systematic approach to break the single real estate asset down into its many component parts resulting in both §1245 and §1250 property.
Goal is to reclassify a portion of real property to personal property so that depreciation deductions can be accelerated.

Shift 1250 = > 1245

Manufacturing Building was purchased for $3,000,000.

The owner had a cost segregation study performed.
Purchased Office Building

- Purchase Price: $2 million
  - 1250 SL Depreciation = $100,000
  - 1250 150% DB Depreciation = $100,000
  - 1245 200% DDB Depreciation = $300,000

- Sales Price in 2018 = $2,300,000
Analysis of Depreciation taken to Date

1. 1250 S/L Depreciation = $100,000

2. 1250 150% DB Depreciation = $100,000

3. 1245 200% DDB Depreciation = $300,000

1. Regular S/L depreciation of our 39 year property. This will be recaptured with the preferential 25% rate.

2. This is accelerated 1250 depreciation. The amount above what would have been regular S/L is hit with the ordinary rate. $5,000 would have been our slow S/L depreciation. Therefore, $5,000 will be taxed with the 25% rate and the remaining $95,000 will be taxed at ordinary rates.

3. All 1245 depreciation is recaptured at ordinary rates.
Office Building Purchase; Total Tax on Sale

- Initial Investment = $2M
- Depreciated $500K
- Adjusted Basis $1.5M
- Sale Price = $2.3M
- Depreciation $500K
- Adjusted Basis $1.5M
- Appreciation $300K (capital gain)
- Total Tax: $232K

- Capital gain = $60K ($300K x 20%)
- 1245 Recapture = $111K ($300K x 37%)
- 1250 Recapture = $35K ($95K x 37%)
- 1250 Recapture = $26K ($105K x 25%)
- Total tax: $232K
## Cost Segregation Study Results

<table>
<thead>
<tr>
<th>Asset Description &amp; Recovery Period</th>
<th>Property Type</th>
<th>Total Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Property, 39-Year</td>
<td>1250</td>
<td>$1,600,000</td>
</tr>
<tr>
<td>Land Improvements, 15-Year</td>
<td>1250</td>
<td>$200,000</td>
</tr>
<tr>
<td>Office Furniture &amp; Fixtures, Other Property, 7-Year</td>
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<td>$400,000</td>
</tr>
<tr>
<td>Computer Equipment, Data Handling Equipment, Distributive Trade Equipment, 5-Year</td>
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<td>$600,000</td>
</tr>
<tr>
<td>Land</td>
<td>NC</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
Now consider this property is exchanged for a like-kind real property

The new property also has a cost segregation study performed
## FMV of Both Properties in the Exchange

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Relinquished Property</th>
<th>Replacement Property</th>
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<tbody>
<tr>
<td>FMV of Property</td>
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<tr>
<td>Land</td>
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</table>
Per Reg 1.48-1(c): “Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property.

Case law for 1031 Exchange suggests that state law should be followed to determine if a property is like kind.
Even though the exchange will be allowed, this does not preclude a portion of the exchange being subjected to recapture under 1245.

1245 Recapture will result:

1. To the extent any taxable boot is recognized in the exchange
2. To the extent the FMV of the relinquished property exceeds the FMV of the replacement property (but not in excess of the gain)
Recapture Resulting from our Exchange

- In an exchange we only need to look at our 1245 property for potential recapture impact:
  
  - In our example we had 1 million in 1245 property of which $300,000 was depreciated for an adjusted basis of $700,000
  
  - We exchanged this for 1245 property with only a value of $500,000 so the difference, $200,000, is our recapture amount (as long as it does not exceed the $300,000 in previous additional depreciation deductions previously taken)
Cost Segregation benefits almost always outweigh the potential recapture on property at the time of exchange.

Consider choosing a replacement property with a similar or higher basis in segregated 1245 property if possible.

Take-Aways
Planning Considerations
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 24% bracket.
- Depreciation recapture on Sec. 1245 property cannot offset capital losses.
- It also matters for **like-kind exchanges**, especially after the tax reform! Only real property can be exchanged!
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.

Warning: only real property (Sec. 1250) can be exchanged after the tax reform! Cost segregation complicates 1031 exchanges!
Section 1250 tax planning

Like-kind (Sec. 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 (Sec. 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.
Questions?