Cost Recovery and Depreciation Recapture

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To accurately forecast the after tax cash flows of real estate dispositions, today's investor must be familiar with special rules for determining the tax on gains and losses, which are contained within the Internal Revenue Code. Internal Code Sections 1231, 1245 and 1250 provide the foundation for the IRS' depreciation recapture regulations, which can significantly impact the after tax cash flows of your sale.

Cost Recovery Recapture

In general, sales of your business property will produce §1231 gains and losses which are netted against one another. If the result is a net loss, the loss is fully deductible against ordinary income and is not subject to capital loss limitations. If the result is a net gain, the beneficial long-term capital gain treatment applies to the gain in excess of your nonrecaptured §1231 losses. These general rules provide substantial benefits to a real estate investor. But you may be asking yourself, what is a nonrecaptured §1231 loss? And what is the catch?

Section 1231 Recapture

Section 1231 recapture is the catch. If you have deducted a §1231 loss within the past five years and are currently reporting a net §1231 gain, §1231 recapture applies to you. As an individual taxpayer, the prior year §1231 losses, which you have deducted against ordinary income, are tracked on a five-year rolling basis. The sum of these losses, which have not already been recaptured, are referred to as your nonrecaptured §1231 losses. As a taxpayer with nonrecaptured §1231 losses, your current year net §1231 gains will be reclassified to ordinary gains to the extent of your nonrecaptured §1231 losses. Only the portion of your gain above your nonrecaptured §1231 losses will receive the beneficial long-term capital gains treatment.

Depreciation Recapture

When you dispose of depreciable property at a gain, the rules and regulations under §1245 and §1250 are first applied to determine if you must recharacterize all or a portion of your gain as ordinary income. The purpose of these regulations is to align your gain with the ordinary deductions, i.e., depreciation, from which you previously benefited. In essence, the regulations prevent or reduce a taxpayer's ability to use tax rate arbitrage by requiring the taxpayer's gain on the disposition of business property to be reclassified as ordinary income. We can see the impact on cash flows more clearly through the following example in which the recapture rules are not applied:

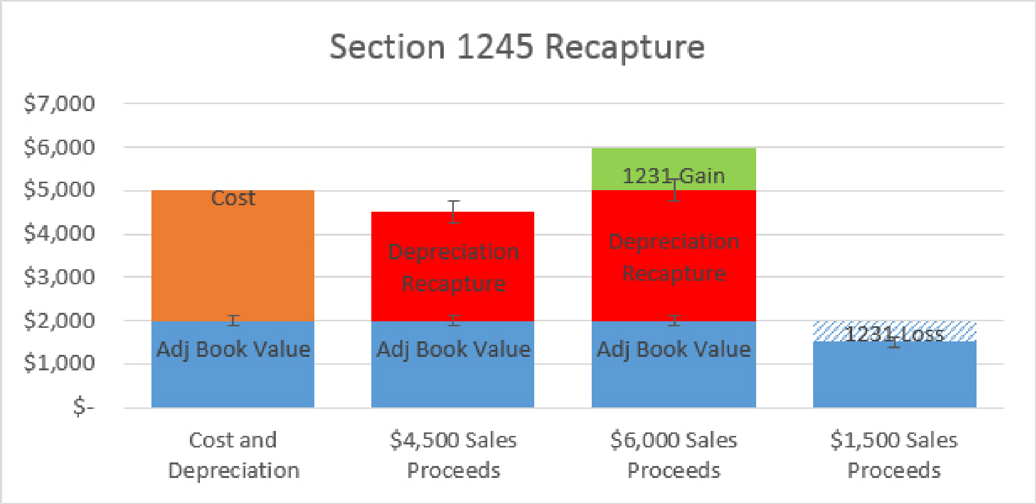
Example 1:

Bob purchases furniture for a residential apartment complex in Yr. 1 for $50,000 and expenses the entire cost under §179. At an ordinary income rate of 35%, his after tax cash outlay is $50,000 x (1 – 35%) = $32,500. Two years later, he sells the furniture for $50,000, the same price he purchased it at. If the recapture rules were not in place, Bob would pay tax on the gain at a capital gain rate of 15%. His after tax cash flow on the sale is $50,000 – (($50,000-0) * 15%) = $42,500. Through this scenario, Bob has gained $10,000 in after tax cash flow due to the flux in tax rates.

Section 1245 Recapture

Two types of depreciation recapture are covered under the recapture regulations – §1245 and §1250 recapture. Section 1245 recapture, sometimes referred to as full recapture, requires a taxpayer to recapture gain as ordinary income to the full extent of his or her previous depreciation deductions. The rules for §1245 recapture apply to all §1245 property used in your trade or business (furniture and fixtures, office equipment ect.)—whether or not you have met the holding period required to be classified as a §1231 asset.

In most instances, the sales price on §1245 property will be less than the original purchase price and the entire gain will be recharacterized as ordinary income, as shown in the scenario below when $4,500 is realized on the disposition of an asset with an adjusted book value of $2,000. The chart on the following page is helpful in visualizing this calculation.



As the chart above illustrates, the amount of gain converted through §1245 recapture will not exceed your previous ordinary deductions on that property. As shown in the scenario where $6,000 is realized on the sale, any gain above the total depreciation taken will continue to be taxed as §1231 gain. Finally, when a taxpayer realizes a loss on §1245 property, no recharacterization provisions apply (a §1231 loss is recognized).

Example 2:

Using the same information from Example 1, above, and implementing the §1245 depreciation recapture rules, Bob must now pay tax on his gain of $50,000 at a rate of 35%. Bob's after tax cash flow is reduced to the amount of his initial cash outlay $50,000 – (($50,000-0) * 35%) = $32,500.

Section 1250 Recapture

Section 1250 recapture applies to §1250 property, such as buildings and structural components. This recapture is calculated when you 1) have taken depreciation in excess of the amounts calculated using the straight-line depreciation method or 2) you dispose of §1250 property you held for one year or less. In both these scenarios, a taxpayer is deemed to have taken additional depreciation, which is recaptured as ordinary income. Section 1250 also requires any gain which is not recaptured (referred to as unrecaptured 1250 gain) to be recharacterized to a maximum 25% capital gains rate. Unrecaptured 1250 gain is all or a portion of your gain on the disposition of §1250 property, which is due to your previous depreciation deductions.

The tax treatment of your gain on the sale of depreciable real estate can be complex and influenced by many factors including the "catch" mentioned above. Boulay is experienced in helping our clients determine the tax consequences of their specific transactions. Contact us to discuss how these rules may apply to your individual tax situation at 952.893.9320 or learnmore@boulaygroup.com.