The Catch: Depreciation Recapture

IF section 1231 applies, you must check to see if depreciation taken will have to be recaptured

Why depreciation recapture?

Depreciation is a form of capital recovery ideally, depreciation = actual economic decline in value of asset for tax purposes, depreciation follows a set schedule, regardless of actual decline in value when an asset is sold • depreciation is recaptured FIRST, to represent the excess of depreciation taken greater than the actual economic decline if any ∘ then section 1231 applies

Types of Section 1231 property

Section 1245 property

- tangible personal property example:
- machinery and equipment

Section 1250 property real property

- example: building and structures
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Taxation and section 1245

depreciation is recaptured (as ordinary income) to the extent of any given

- all depreciation must be recaptured before capital gains treatment under 1231 applies

4 possible outcomes

If Sale Price:	AR = AB*	AR < AB*	AR > AB* and Gain < Depreciation	AR > AB* and Gain > Depreciation
Tax Consequences	No gain or loss, no depreciation recapture, no tax consequences.	Resulting loss is always treated as an ordinary loss.	Section 1245 treats the gain as ordinary gain.	Gain up to the amount of depreciation taken is treated as ordinary gain under Section 1245. Gain in excess of depreciation taken is treated as capital gain under Section 1231.
Resulting from Economics	Accounting estimate of depreciation equals economic reality.	Not enough depreciation was taken	Too much depreciation was taken	Too much depreciation was taken and the asset appreciated.
Illustrated By	Example 12.3	Example 12.4	Example 12.5	Example 12.6
*AR = Amount Realized; AB = Adjusted Basis				

Tax consequences section 1245 asset

	Example 12.3	Example 12.4	Example 12.5	Example 12.6
Amount Realized	$1,100	$1,000	$1,200	$1,700
Adjusted Basis	$1,100	$1,100	$1,100	$1,100
Gain / (Loss)	$0	($100)	$100	$600
Tax Impact	None	Ordinary Loss ($100)	Ordinary Gain $100 (Gain is less than depreciation taken)	Part ordinary gain ($400), part capital gain ($200) (Gain is more than depreciation taken)
Economic Reality	Depreciation estimate was perfect	Taxpayer took too little depreciation	Taxpayer took too much depreciation	Taxpayer took too much depreciation and asset appreciated

Taxation and section 1250

depreciation taken > straight line depreciation is recaptured (at ordinary rates)

unrecaptured section 1250 depreciation aka: straight line depreciation taxed at a flat

- 25% rate (or marginal rate, if lower)
- Excess gain is capital gain under section 1231

EXAMPLE

Less purchased an office building for $1,000,000. He has taken depreciation deductions of $300,00 (straight line depreciation would have been $200,00) at the time that he sold the building for $1,500,00

		Gain Taxation		
Amount Realized	$1,500,000	Ordinary Income	$100,000	← Recaptured § 1250 Depreciation
Adjusted Basis	($700,000)	25% Tax Rate	$200,000	← Unrecaptured § 1250 Depreciation
Total Gain	$800,000	Capital Gain	$500,000	
			$800,000	

Steps to determining tax consequences of section 1231 assets

1. categorize the asset (section 1231)
2. calculate gain or loss
3. consider depreciation recapture
    a. if personal property - section 1245
    b. if real property - section 1250
4. apply best of both worlds rule

Recapture rules and tax planning

gifts depreciation recapture potential carries over to donee

Non-taxable exchanges depreciation recapture carries over to the replacement

property testamentary transfers section 1014 "step-up" extinguishes recapture

potential charitable contributions if deductions is normally valued at FMV, must reduce

deduction by amount of potential depreciation recapture

Installment sales including SCINs and private annuities installment reporting

provisions do not apply to depreciation recapture recapture occurs when

gain is realized

- unrecaptured section 1250 depreciation may be deferred, but all of gain in each
- installment year will be taxed at 25% until all straights line depreciation is recaptured

5 year look back rule

section 1231 netting process • gains and losses

for the year are netted tax planning

- would be better recognize section 1231 gains in one year, and section 1231 losses in another year

5 year look back rule

- net section 1231 gain in current year is taxed at ordinary rates to extent of unrecaptured section 1231 losses in the last 5 years

EXAMPLE

Colin has a Section 1231 gain for the current year (2023) of $15,000. In prior years, Colin had the following net Section 1231 transactions:

	Year	Net Section 1231 Transaction
5-Year Look-back Period	2022	$4,000 Section 1231 Loss
	2021	$2,000 Section 1231 Loss
	2020	No Section 1231 Transactions
	2019	No Section 1231 Transactions
	2018	No Section 1231 Transactions
	2017	$8,000 Section 1231 Gain
	2016	$2,000 Section 1231 Gain

Colin would have to recognize $6,000 of his 2022 gain as ordinary income since in 2021 and 202 he had section 1231 losses, the remaining 9,000 of Colins section 1231 gain ($15,000-$6,000) would be treated as a section 1231 capital gain