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Depreciation recapture and 1031 exchanges

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Clients wanting to do a Section 1031 exchange plan to avoid paying tax on the otherwise taxable gain. However, Section 1031 is not the only hurdle to cross in achieving tax deferral. Clients must also consider the impact of the "recapture" provisions of Sections 1245 and 1250. The depreciation recapture provisions, when they apply, can do two things: they can recharacterize income from capital gain to ordinary income, and they can sometimes override non-recognition provisions, such as Section 1031.

Section 1245 Recapture

Section 1245 generally applies to personal property. It also includes any portion of real property that has been amortized for expenses incurred to make it handicapped accessible or which has been expensed under Section 179. When Section 1245 property is sold, the amount received is recaptured as ordinary income to the extent of previous depreciation and amortization adjustments, and taxed at the time of sale. When relinquished property in a like-kind exchange is Section 1245 property, the taxpayer must acquire replacement property that is both like-kind under Section 1031 and Section 1245 property to defer the recaptured gain.

A potential trap for the unwary is real property acquired before 1987 that was depreciated under an accelerated method. For such property, the entire amount of depreciation deductions taken (not just the excess over straight line) is recaptured under Section 1245. Since there is little Section 1245 real estate that can be acquired as replacement property, it will be difficult (but not impossible) for a taxpayer in this situation to defer tax on the recaptured gain.

Section 1250 Recapture

Section 1250 relates to depreciable real property other than Section 1245 property. Since land is non-depreciable, it is not considered Section 1250 property. When Section 1250 property is sold, the difference between accelerated and straight line depreciation is recaptured as ordinary income and taxed in the year of sale. When relinquished property in a like-kind exchange constitutes Section 1250 property, to the extent that this "difference" is both like-kind property and Section 1250 property to defer the recaptured gain.

Since real property has been depreciated on a straight line basis since January 1st, 1987, there will be potential Section 1250 recapture relatively infrequently. However, if the relinquished property has been exchanged before, there may be excess depreciation from previously owned properties carried over into the relinquished property.

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