

Depreciation Recapture

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The word “recapture” always makes me think of livestock escaping, only to be later corralled and returned to its pen. Depreciation recapture should be thought of as recapturing a tax benefit that has been accessed and used and now we must recapture it (i.e., pay all or part of it back) because the asset is being disposed.

The tax benefit received from owning depreciable property, and which later may be subject to recapture, is the benefit that allows a deduction for depreciation on the property that can offset *ordinary income* earned by the taxpayer. The purpose of depreciation recapture is to close the loophole (thus the lasso pictured above) whereby the depreciation deduction offsets ordinary income while the gain on the property’s disposal may be taxed as capital gain. Since the tax on capital gain income is often less than the tax on ordinary income, there could be a definite advantage given to the taxpayer. To close this loophole, IRS Code Sections 1245 and 1250 were created. Now, when you dispose of an asset, the benefit of an earlier deduction from ordinary income is “recaptured” by recharacterizing all or part of the gain on the disposal as ordinary income and *not* capital gain.

The depreciation recapture rules contained in Sections 1245 and 1250 apply to business property that is being disposed at a gain and that has been depreciated, amortized, or expensed under Section 179. (There are certain exceptions, however.) The recapture rules for Section 1245 property differ from those for Section 1250 property.

Section 1245 versus 1250 Property

Whereas Section 1245 property consists mainly of depreciable personal property, Section 1250 property consists only of depreciable real property. The treatment of the gain on the disposal of property is handled differently for each of these code sections. The principal reason behind the difference in how the gain is treated is that it is considered likely that at

least part of the gain on the sale of Section 1250 real property will be due to the property's appreciation or inflation, and not only due to the depreciation expense that was claimed on it

Another difference between these two code sections is that once property is classified as Section 1245 property, it will always be treated as such. Therefore, if a previous owner of an asset depreciated it and the present owner does not, the asset is still considered to be Section 1245 property. Section 1250 property, on the other hand, can be converted into Section 1245 property and, when this occurs, the property will be treated as if it was always Section 1245 property (with any Section 1250 depreciation previously claimed on it, subject to recapture).

There are different sets of rules for recapturing depreciation on the disposal of property based on whether the property is classified under Section 1245 or 1250. The recapture rules under Section 1245 treat the part of the gain attributed to depreciation claimed as ordinary income. The amount of gain recognized as ordinary is the lesser of:

- The amounts allowed or allowable for depreciation, or
- The amount of gain realized, if it is a sale, exchange, or involuntary conversion, or, for all other types of dispositions, the amount by which the property's fair market value exceeds its adjusted basis.¹

Alternatively, the recapture rules under Section 1250 treat as ordinary income only that part of the gain attributed to any "additional depreciation" allowed or allowable on the property. The amount of this additional depreciation is computed differently depending on how long you've held the property. If you have held the property for a year or less, additional depreciation is *all* of the depreciation on the property. If you have held the property for *more than* a year, the additional depreciation is the lesser of:

- That portion of the depreciation that exceeds what would have been allowed if straight-line depreciation had been claimed, or
- The amount of gain realized (or, depending on the type of disposal, the excess of the property's fair market value over its adjusted basis).

Which code section applies depends on how the property is classified. Section 1245 property (enacted in 1962) includes all depreciable personal property (tangible or intangible) and certain types of depreciable real property. See the article, [Defining Section 1245 Property](#), in our Fixed Assets Expert Center, for a complete description of which property qualifies for Section 1245 treatment.

¹ Like-kind exchanges receive unique treatment and will not be covered in this article.

Section 1250 property (enacted in 1964) is any depreciable property *other than Section 1245 property*. Therefore, Section 1250 property is mainly buildings and their structural components.

Note: To read about which expenditures relating to a fixed asset can be expensed rather than capitalized and depreciated see [“Property Expenditures: Capitalizing versus Expensing”](#) in our Fixed Assets Expert Center.

Depreciation Recaptured as Ordinary Income

Depreciation that must be recaptured as ordinary income includes:

- Ordinary depreciation
- Amortization
- Any special depreciation allowances (e.g., bonus depreciation)
- Section 179 expense
- Any deductions for the following:
 - Removing barriers for the elderly or disabled
 - Environmental cleanup costs
 - Reforestation expenses
 - Any basis reduction for the Investment Credit
 - Any basis reduction for the qualified electric vehicle credit
 - Tertiary injection expenses

Dispositions Triggering Depreciation Recapture

Although there are a few exceptions, most dispositions of either Section 1245 or 1250 property will trigger depreciation recapture on any taxable gain. A “disposition” includes sales, taxable exchanges, transfers, and involuntary conversions of property.

Some other less common types of dispositions that may trigger recapture are: a gift of property that has a mortgage valued at more than the property’s adjusted basis, a relinquishment of a vessel under a federal fishing reduction program, and a conversion of listed property to 50% or less business use.

Depreciation recapture accelerates the recognition of gain when there is an installment sale of depreciated property. When an installment sale occurs, the gain is reported over the period of time during which the payments are received, but the total amount of any depreciation recapture is fully recognized in the year of the sale *even if no payments towards principal are received that year*.

There are two types of dispositions which may delay or limit the amount of depreciation recapture:

- Tax-free carryovers² where the transferor's adjusted basis becomes the transferee's basis (such as a gifts or a Section 351 transfer to a controlled corporation), and
- Tax-free rollovers where the property's adjusted basis becomes the basis for the replacement property acquired by the transferor (such as a like-kind exchange and an involuntary conversion).

Therefore, when either of the above occurs, although depreciation recapture is not required initially, it may be required on a subsequent disposition of the property. The depreciation recapture requirement is actually transferred from one taxpayer to another.

It is important to note that transfers at death do *not* require depreciation recapture.

Miscellaneous but Important

There are various other important facts about depreciation recapture:

- When more than one kind of property is disposed of in the same transaction that includes either Section 1245 or Section 1250 property, the amount realized must be allocated to the different types of property based on their respective fair market value.
- The amount of depreciation recapture cannot exceed the gain on the transaction.
- Certain transfers of property to a tax-exempt organization may be exempt from the recapture rules if the property is to be used in an unrelated trade or business *and* it is made under one of the following Code Sections: a Section 332 liquidation, a Section 351 transfer, a Section 361 reorganization transfer, a Section 721 partnership transfer, or a Section 731 partnership distribution.
- A tax-exempt organization must recapture depreciation on property for any period of time during which it owned the property and it was not tax exempt.

Conclusion

Depreciation recapture can be an important consideration when doing tax planning. First, in order to correctly apply the depreciation recapture rules, you must be able to distinguish between Sections 1245 and 1250 property. How significant a factor it will be depends, at the time of the property's disposal, on whether there is a significant difference between the current capital gains rate and the regular tax rate.

² If a carryover is partially taxable, then depreciation recapture is required on the recognized portion of the gain.

By recharacterizing all or part of the gain on the disposition of property as ordinary, several things can happen. If, for example there is a large NOL carryforward about to expire, depreciation recapture can help absorb the NOL. On the other hand, depreciation recapture can cause the amount of any capital loss deduction to be limited by decreasing the amount of capital gain that might have been offset by it. And of course, depreciation recapture can significantly reduce the advantage of selling property on an installment sale since it may accelerate the recognition of gain.

Whenever a choice is possible, it is always more beneficial to expense property rather than capitalize it and depreciate it. (This does *not* include Section 179 expensing, however, as such expense is treated the same as depreciation for the purpose of depreciation recapture.) Expensing property not only gives the taxpayer a quicker writeoff, but, in addition, the property won't be subject to depreciation recapture at a later date.