KBKG Tax Insight: Avoiding Cost Segregation Recapture Tax

Savvy tax professionals that recommend Cost Segregation studies are well aware of the recapture tax rules that require taxpayers to pay back any accelerated tax deductions when the property is sold. After all, for the right situation, the net present value of those tax savings far exceeds any recapture tax payback. While the effects of a Cost Segregation study can magnify recapture issues, tax professionals should consider a number of worthwhile opportunities to reduce or avoid recapture tax that is realized upon sale of property.

Recapture: An Overview

Recapture was enacted to close a tax loophole that arose by allowing taxpayers to take depreciation deductions that offset ordinary income while taxing gains from the subsequent sale of those depreciated assets at lower capital gain rates. The loophole was closed by taxing gains attributable to depreciation deduction previously taken at rates higher than those available for capital gains. Depreciation recapture often requires that a portion of the gain be taxed at rates as high as 25% (for real property) and 39.6% (for personal property). Nonetheless, many taxpayers are under the impression that all gains generated from the sale of real estate are taxed at capital gain rates.

Valuation of Personal Property at Time of Sale

When a property is sold, the fair market value of Section 1245 personal property in a building may be uncertain. The seller can minimize recapture by allocating more of the sale price to real property instead of personal property. In many situations, personal property in a building may have little to no value. For example, carpeting and certain other §1245 personal property installed a decade ago likely has minimal worth, especially if the new owner has plans to replace it. As such, it would be appropriate to allocate only a nominal amount of the building's sale price to carpeting. Thus, proper valuation of the personal property may yield lower overall recapture tax.

Partial Dispositions

The new Tangible Property Regulations (TPRs) allow taxpayers to carve out and dispose of components removed or demolished from a building. Taxpayers can take losses on the remaining basis amounts for roofs, windows, HVAC systems, and other building components that have since been replaced. By making partial dispositions, taxpayers also avoid subsequent recapture on these items. It is important to note that partial dispositions must be made in the year of disposition, as these cannot be modified by a change in accounting method.

Case Study: Consider a building was purchased in 2009 for $5M and then a renovation occurs in 2012 that results in demolition of $470K worth of interior components. A tax professional that incorrectly continues to depreciate these assets could mistakenly calculate recapture tax upon sale. If $370K was 39 year property and $100K was 5 year property, the recapture tax would be approximately $127,500 ($370K x 25% + $100K x 35%). On the other hand, if a partial disposition was made timely, there would be zero recapture tax on these components. Instead the taxpayer would pay capital gains on them in the amount of $94K ($470K * 20%). Thus, by properly claiming a partial disposition, the taxpayer will realize permanent tax savings of $33.5K upon sale.

Retirements

While partial dispositions are required when a component of a larger tax asset is removed, retirements generally occur when building components are separately stated on the tax depreciation schedule.

Similar to partial dispositions, it is important for taxpayers to carefully review depreciation schedules for these and remove them to avoid recapture. For items retired in prior years that are mistakenly still being depreciated, taxpayers are allowed to make an automatic change in accounting method at any time to correct this (Designated Change #205).

KBKG Insight: When tenant improvements are separately stated on the depreciation schedule, tax professionals should verify that these improvements are still in place. If the tenant has since left and the old space has been demolished, a retirement loss deduction should be realized.

Repair vs. Capitalization

The new TPRs provide much needed guidance as to what can be treated as a repair expense and what requires capitalization. Replacing a roof membrane or replacing one of three furnaces of a building's HVAC system are examples of repair and maintenance expenses. Improperly capitalizing these costs not only increases current tax liability, but also creates unnecessary recapture tax upon sale of the building. In many situations, taxpayers have the opportunity to retroactively correct this treatment by making an automatic change in accounting method (Designated Change #184).

Like-Kind Exchange (IRC §1031)

Generally, no gain or loss is recognized for taxpayers that exchange business or investment property solely for business or investment property of a like-kind under IRC §1031; nevertheless, recapture tax may be required even when there is an even exchange of real estate. However, when a Cost Segregation study is performed on a relinquished property, §1245 recapture tax can be avoided as long as there is equal or more personal property in the newly acquired property. This often requires a Cost Segregation study on the newly acquired property, but to avoid surprises after it is complete, tax professionals should work closely with experienced Cost Segregation professional to estimate the allocations of various tax life categories for the newly acquired property in the exchange.

Conclusion

Recapture issues should be addressed prior to the contemplated sale of an asset. By following some practical strategies and working with a trusted specialty firm along the way, savvy tax professionals can eliminate unnecessary recapture tax upon sale. KBKG's experts can assist in this process by providing the technical knowledge, tools, and experience to handle any recapture issues resulting from the sale of a building.

Author: Gian Pazzia, CCSP. Contributing Author: So Sum Lee, CPA