

# Depreciation Recapture: Deferral Through Like-Kind Exchange

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**Depreciation recapture is a critical concept in U.S. tax law that affects taxpayers who dispose of depreciable property, such as real estate or business equipment. When a taxpayer sells or exchanges property that has been depreciated, the IRS may require that some or all of the gain be "recaptured" and taxed as income. However, under certain circumstances, notably a like-kind exchange under Internal Revenue Code (IRC) § 1031, the recognition of this recapture can be deferred.**

Depreciation recapture applies when you sell or exchange property for which you have claimed depreciation deductions. For real property, the relevant rules are found in IRC §1250. If the property is sold for more than its adjusted basis (original cost minus accumulated depreciation), the portion of the gain attributable to depreciation may be taxed as ordinary income, up to the amount of depreciation previously claimed. For example, if you purchased a building for \$500,000, claimed \$100,000 in depreciation, and later sold it for \$600,000, the \$100,000 of depreciation is subject to recapture and may be taxed at higher ordinary income rates, while the remaining gain may be taxed at capital gains rates.

A like-kind exchange, governed by IRC §1031, allows taxpayers to defer recognition of gain (including depreciation recapture) when they exchange real property held for productive use in a trade or business or for investment for other real property of like kind. The key requirement is that both the relinquished and replacement properties be held for business or investment purposes, and that the exchange be structured to meet the identification and timing rules.

When a like-kind exchange is properly executed, no gain or loss is recognized at the time of the exchange, including any gain that would otherwise be subject to depreciation recapture. Instead, the basis of the new

property is generally the same as the basis of the old property, adjusted for any additional consideration paid or received. The deferred gain, including the recapture amount, is "carried over" to the replacement property. This means the recapture is not eliminated but postponed until the replacement property is sold in a taxable transaction.

If, as part of the exchange, the taxpayer receives "boot" (cash or non-like-kind property), gain is recognized to the extent of the boot received. In this case, depreciation recapture is recognized up to the amount of gain realized or the amount of boot, whichever is less.

In conclusion, depreciation recapture can significantly increase the tax liability upon the sale of depreciated property. However, by utilizing a like-kind exchange, taxpayers can defer both capital gains and depreciation recapture, preserving cash flow and investment capital. If interested in this tax strategy, it is important to consult with an experienced tax professional to ensure all procedural requirements are met and to provide assistance if the deferred recapture is triggered by a subsequent taxable disposition of the replacement property.