

What is Depreciation Recapture?

When using a DST in a 1031 exchange, two of the largest monetary benefits investors receive are deferring capital gains tax and depreciation recapture tax. A real estate investor can claim depreciation against their property on an annual basis. This allows the investor to deduct the depreciable amount from their taxable income, lowering their tax burden for that fiscal year.

When the investor makes a profit from the sale of the property, the depreciation used to offset taxable income from previous years will be recaptured by the IRS. The depreciation recapture tax rate is set at the taxpayer's ordinary income tax rate, opposed to the capital gains tax rate. In 2019, the depreciation recapture tax rate was capped at 25% while capital gains tax was 15%. Tax rates shown are illustrative and may not reflect current rates. Consult your tax professional for applicable rates.

When using a DST in a 1031 exchange, an investor gains not only deferred capital gains taxation, but deferred depreciation recapture taxation as well.

AN EXAMPLE OF DEFERRED DEPRECIATION RECAPTURE TAX

An investor bought an investment property 10 years ago for \$150,000 and made no improvements. They used straight-line depreciation for \$15,000 annually, bringing their adjusted cost basis to \$0. Now they want to sell the property.

What if they did not want to 1031 exchange into a DST, but use the proceeds for their retirement? They are now subject to paying not only a capital gains tax, but a depreciation recapture tax as well. The investor sells the property for \$329,000 (net of selling expenses).

Sale Economics	
Sold Property Price	\$350,000
Selling Expenses (6%)	\$(21,000)
Net Proceeds	\$329,000
Capital Gains	\$179,000
Depreciation Recapture	\$150,000
Taxable Proceeds	\$329,000
Tax Calculation	
CG Tax (15%)	\$26,850
DR Tax (25%)	\$37,500
Total Tax from Sale	\$64,350

Key Takeaways

Since they used depreciation on their investment property to lower their tax burden annually the past 10 years, they will now be paying a capital gains tax of 15% on \$179,000 and a depreciation recapture tax of 25% on \$150,000.

Their total tax burden now becomes \$64,350 on the sale of the investment property which is 36% of their capital gain.

If they were to DST 1031 exchange, taxes may be deferred to a future date through a qualifying 1031 exchange into a DST. Tax deferral is not tax elimination — deferred taxes become due upon ultimate disposition of the replacement property.

Hypothetical Disclosure: The information herein is a hypothetical illustration of mathematical principals only. It is not, nor can there be, any guarantee that any investment will achieve its stated objectives.

Disclosures

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1031 EXCHANGE RISK DISCLOSURE

- There is no guarantee that any strategy will be successful or achieve investment objectives including, among other things, profits, distributions, tax benefits, exit strategy, etc.
- Potential for property value loss: All real estate investments have the potential to lose value during the life of the investments.
- Change of tax status: The income stream and depreciation schedule for any investment property may affect the property owner's income bracket and/or tax status. An unfavorable tax ruling may cancel deferral of capital gains and result in immediate tax liabilities.
- Illiquidity: These assets are commonly offered through private placement offerings and are illiquid securities. There is no secondary market for these investments.
- Impact of fees/expenses: Costs associated with the transaction may impact investors' returns and may outweigh the tax benefits.
- Stated tax benefits: Any stated tax benefits are not guaranteed and are subject to changes in the tax code. Speak to your tax professional prior to investing.