DEPRECIATION RECAPTURE: WHAT DOES IT MEAN TO YOU?

PETER BLUMKIN, CPA, CGMA
MAY 2013
DEPRECIATION RECAPTURE:
WHAT DOES IT MEAN TO YOU?

Over the past decade, business owners have been reaping generous tax benefits by writing off their new equipment purchases, including certain qualified leasehold improvements. The special first-year allowable write-off, called “bonus depreciation”, initially was set at 30% of the asset’s purchase price and, over the years, was raised to 50%. For the period of September 9, 2010 through December 31, 2011, it even reached 100%. What many taxpayers fail to realize, however, is that some or all of the previously-derived tax benefits could be negated when the affected assets are disposed of.

It’s important, therefore, to review the rules which should be considered carefully before disposing of a business asset.

Any amount of gain realized on the sale of business assets is first allocated to prior depreciation taken and is taxed as ordinary income instead of capital gain. Depreciation recapture applies to the disposition of an asset that is held more than a year, is subject to depreciation or amortization and is disposed of at a gain. A common misconception exists that a business asset disposed of at a gain automatically qualifies for a 15% preferential capital gain tax rate (20% for the taxpayers in a 39.6% tax bracket). This is where the recapture rules come into play.

The IRS reclassifies the character of the gain on the disposed asset from that of capital into ordinary to the extent the depreciation or amortization deduction is allowed or allowable. All tangible depreciable personal property and intangible amortizable personal property are subject to the recapture provisions. The impact of recapture is somewhat lessened on the gain derived from real property disposition. Depreciation taken on that property is subject to the 25% tax rate, to the extent of the gain. There is still some good news: Any gain in excess of the amounts recaptured is treated as capital gain and currently taxed at 15% or 20%. Recapture provisions can also apply when selling a business.

A special situation applies to an asset disposed of on an installment basis. Whereas the gain on the installment sale is recognized in income as the payments come in, any depreciation recapture becomes taxable in the year of sale, even if no cash is received. The far reaching repercussions of these rules can be felt when selling or transferring a partnership interest. A proportionate share of an individual partner’s indirect ownership of the partnership’s depreciable fixed assets is also subject to ordinary income recapture rules.

With proper planning, depreciation recapture can be reduced, shifted, postponed or even eliminated.

Reducing recapture effects can be accomplished by recognizing ordinary income when the taxpayer is in a low tax bracket or when he or she has a net operating loss carryover. If a taxpayer makes a bona fide gift of depreciable property, the recapture potential will be shifted to the donee. One can postpone the recapture provisions by completing a like-kind exchange, in which case the recapture is not triggered upon the exchange, but rather, is carried over to the replacement property.

With the Bush-era tax breaks extended through the end of 2013, it is more important than ever to recognize that while taking “bonus depreciation” or Sec. 179 deduction on leasehold improvements will almost always be beneficial, using the same approach on personal property assets will only defer the recapture. More planning is warranted in many such instances.
DEPRECIATION RECAPTURE:
WHAT DOES IT MEAN TO YOU?

About Peter Blumkin

Peter Blumkin, CPA, CGMA is a Senior Manager in the Tax Department at Marks Paneth & Shron LLP. Mr. Blumkin, who joined MP&S in 2009, has more than 15 years of experience advising high-net-worth individuals and their businesses. He also has strong tax knowledge in corporate and partnership areas. He is a member of New York State Society of CPAs and American Institute of CPAs.

Contact Peter Blumkin:
Phone: (212) 201-2208; Fax: (212) 201-2209
pblumkin@markspaneth.com

About Marks Paneth & Shron LLP

Marks Paneth & Shron LLP is an accounting firm with over 500 people, of whom nearly 65 are partners and principals. The firm provides public and private businesses with a full range of auditing, accounting, tax, consulting, bankruptcy and restructuring services as well as litigation and corporate financial advisory services to domestic and international clients. The firm also specializes in providing tax advisory and consulting for high-net-worth individuals and their families, as well as a wide range of services for international, real estate, media, entertainment, nonprofit, professional and financial services, and energy clients. The firm has a strong track record supporting emerging growth companies, entrepreneurs, business owners and investors as they navigate the business life cycle.

The firm’s subsidiary, Tailored Technologies, LLC, provides information technology consulting services. In addition, its membership in Morison International, a leading international association for independent business advisers, financial consulting and accounting firms, facilitates service delivery to clients throughout the United States and around the world. Marks Paneth & Shron LLP, whose origins date back to 1907, is the 32nd largest accounting firm in the nation and the 16th largest in the New York area. In addition, readers of the New York Law Journal rank MP&S as one of the area’s top forensic accounting firms for the third year in a row.

Its headquarters are in Manhattan. Additional offices are in Westchester, Long Island and the Cayman Islands. For more information, please visit www.markspaneth.com.