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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%.

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

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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? Well 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

- 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

Tax Calculation

CG Tax (15%)	$26,850
DR Tax (25%)	$37,500
Total Tax from Sale	$64,350

- If they were to DST 1031 exchange, all those taxes would be deferred, and no taxes would be paid in the current year

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