
**Recapture of Bonus Depreciation**

100% bonus depreciation throughout 2011, and now 50% bonus in 2012, has been particularly beneficial to agricultural producers. Farmers and ranchers can apply bonus depreciation to their general purpose buildings, due to the 20-year recovery period. But in some cases that will lead to harsh ordinary income depreciation recapture if a disposition occurs within that 20-year period.

**Background**

Bonus depreciation, enacted within IRC Sec. 168(k), has been on and off in our tax system for a number of years. It originally was an economic recovery tool following the 9/11 terrorism attack, and remained in the tax system from late 2001 through 2004. In those days, it was either a 30% or 50% first-year deduction.

When the recession began in 2008, Congress again turned to bonus depreciation as an economic incentive, allowing a 50% rate initially. The rate increased to 100% for assets acquired and placed in service from September 9, 2010 through December 31, 2011, but reverts to 50% for calendar year 2012 before expiring in 2013.

With respect to Section 1250 buildings, only accelerated depreciation in excess of straight-line creates ordinary income recapture. So how does 50% or 100% bonus depreciation affect gain recognition when a disposition occurs?

**Guidance in the Regulations**

Farm machine sheds and shops are general purpose structures categorized as Section 1250 property. Depreciation on Section 1250 property normally qualifies for capital gain treatment, although a special 25% rate is applied under IRC Sec. 1(h)(1)(D), to the extent gain is attributable to prior depreciation.

Under IRC Sec. 1250(a)(1)(A), only post-1975 “additional depreciation” is treated as ordinary income with respect to buildings. IRC Sec. 1250(b)(1) defines “additional depreciation” as the amount claimed in excess of straight-line. General purpose farm buildings may be depreciated using the 1.5 DB method under IRC Sec. 168(b)(2)(A) or (B), so there is always some exposure to ordinary income if a sale occurs within the first 20 years.

Reg. 1.168(k)-1(f)(3) states that for purposes of Section 1250 ordinary income depreciation recapture, the bonus depreciation deduction is not considered a straight-line method. As a result, bonus depreciation is considered an accelerated deduction, and to the extent it is in excess of straight-line, ordinary income recapture results upon disposition.

**Example.** Art, a farm proprietor, acquires and places in service during 2011 a $200,000 machine shed-shop structure at a cost of $200,000, and claims 100% bonus depreciation. Nine years later, Art has a health problem, retires from farming, and sells the real estate that includes the machine shed that was entirely expensed in 2011. At the point of sale, assume that Art and the buyer agree that the building is worth $130,000. Art has zero basis in the building because of the prior 100% bonus depreciation, but had he claimed 20-year straight-line cost recovery on the machine shed, assume that he would have claimed $90,000 of straight-line depreciation. In that case, the $200,000 structure would have had an adjusted tax basis of $110,000 at the time of
sale.

Art claimed $200,000 of bonus depreciation, but would have claimed only $90,000 had he utilized straight-line 20-year cost recovery. Accordingly, he has "additional depreciation" of $110,000 for Section 1250(b) ordinary income recapture purposes. Art's $130,000 gain on the sale of the building is treated as $110,000 of Section 1250 ordinary income recapture and $20,000 of unrecaptured Section 1250 capital gain. The $20,000 amount is taxed at a rate no greater than the 25% capital gain rate. Further, if Art's sale is an installment sale, the ordinary income portion of $110,000 is taxable immediately at the point of sale, regardless of when payments are collected by Art [Sec. 453(i)].

Section 1245 Property
This same regulation states that for purposes of Section 1245 recapture, first-year bonus depreciation is treated as an amount allowed or allowable for depreciation [Reg. 1.168(k)-1(f)(3)]. Of course, that simply means that equipment and other Section 1245 farm property, including special purpose ag structures, will continue to face full ordinary depreciation recapture as has occurred in the past, whether the deductions were claimed using bonus depreciation, Section 179, or traditional MACRS cost recovery.

The Practical Side
The good news about farm buildings is that they are rarely sold. Most retirees who cease their active operation continue to own the land and buildings, even though they have converted to landlord status. However, while the risk is low, providing quality client service suggests that we should communicate this ordinary income recapture consequence to our clients. Here are several paragraphs that might assist in doing so:

In your 20xx tax return, we claimed 100% (or 50%) first-year bonus depreciation on your new (describe asset: machine shed, shop, etc.). This opportunity to claim an immediate deduction for an asset that otherwise would have required 20-year depreciation represented a significant opportunity. However, on a note of caution, we need to advise that any sale or other disposition of this structure within this 20-year period may cause some ordinary income recapture of the bonus depreciation. The tax law requires that any bonus depreciation claimed in excess of what would have been the normal straight-line depreciation produces ordinary income rather than more favorable capital gain rates at sale.

If the structure is held at least 20 years, this ordinary depreciation recapture becomes moot. Further, the amount of ordinary income that may occur on a sale prior to the 20 year point is dependent upon how much value is allocated to that structure. The major point of this message is to recognize that this risk applies to any sale within 20 years, and to seek tax planning advice prior to any disposition of this property.

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