ST COMMERCIAL CAPITAL
REAL ESTATE INVESTMENT FUNDS

INVESTOR PRIMER
DEPRECIATION & RECAPTURE

1 Intro

Understanding depreciation and recapture is critical to a complete understanding of investment in commercial real estate, and has a particular relevance when considering investment in a QOZ Fund.[i] The rules are intricate and complicated, and this Primer takes a 20,000-foot view, and doesn't address differences that exist at the State level.*

2 Depreciation

The Internal Revenue Code (IRC) allows taxpayers to treat the loss of value of a depreciable property (property used by the taxpayer in a business or held for investment and with a limited useful life (i.e., not land) of more than one year[ii]) over time as an expense, i.e. a tax deduction. This process is known as **depreciation**. The IRC prescribes the useful life and method of depreciation, by asset category.[iii] Given that real estate actually tends to *appreciate* over time, this is a great tax benefit of real estate investment.

DEPRECIATION PROCESS:

STEP 1

Basis Established

At purchase, the original basis (Original Basis) for income tax purposes of investment commercial real estate (Property) equals purchase price + certain acquisition costs that are "capitalized" (IRC §1012). In other scenarios, the Original Basis is established under another rule – such as a basis carryover under a 1031 exchange – but *how* the Property's Original Basis was set doesn't affect the subsequent depreciation and recapture process.

STEP 2

Basis Allocated

After establishing the Original Basis, the taxpayer (TP) allocates that basis among the property-types of which the Property is comprised. In a garden variety situation, no purchase price allocation is made in the purchase contract and the buyer will only divide the basis into two parts: a single depreciable category and the non-depreciable land, in proportion to their relative values. County Assessor valuations are often relied on here.

However, the IRC prescribes the depreciation period and method for numerous asset classes of which most real estate is comprised, under IRC §168 (see Table A). While commercial real estate buildings and their structural components depreciate over 39 years, on a straight-line basis, the remaining components of the Property are depreciated based on their §168 asset class, which classes depreciate over periods as short as 5 years. Thus, the relative value of the different components that make up the Property is used to allocate the overall Original Basis among them. Cost segregation studies are often used in support of allocating large portions of the Property to asset classes with shorter useful lives.

STEP 3

Deductions Taken, Basis Reduced

Each tax year, deductions are applied and reduce TP's taxable income dollar-for-dollar. But every dollar of depreciation deduction also has the effect of reducing the Property's basis by a dollar (IRC §1016(a)(2)), which comes back to bite TP at the time of sale in the form of recaptured taxable income. An interesting aspect of the depreciation rules is the IRC's insistence on TP's use of the largest allowable deductions. [iv]

STEP 4

If Additions Made, Same Cycle Applies

As TP makes additions and capital improvements to the Property over time, these expenditures add to its basis -- then start their own depreciation process as independent elements of the Property.

KEY CONCEPT: REAL PROPERTY COMPRISED OF SEVERAL ASSET CLASSES

Depreciation and recapture concepts are driven by the different asset categories into which the IRC divides real estate, as demonstrated by Table A below.

* For educational purposes only; not tax, legal or investment advice. Federal income tax rules as of October 2026. Not an offer to sell, or a solicitation of an offer to buy, any security.

KEY TERM: "ADJUSTED BASIS"

A frequently-used term representing the changing basis of property as it depreciates over time. At any given point in time, adjusted basis (Adjusted Basis) is determined as follows:

Adjusted Basis = Original Basis - Accumulated Depreciation

KEY CONCEPT: SECTION 1245 PROPERTY & SECTION 1250 PROPERTY

A byproduct of the depreciation process that will be used in the recapture process is that every depreciation (i.e., non-land) component of the Property will be identifiable as either §1245 property or §1250 property:

- **§1245 property** - Personal property segregated out from the rest of the Property in order to accelerate depreciation (e.g., appliances, furniture, equipment and components expensed under §179).
- **§1250 property** - All Property components that aren't §1245 property or land (e.g., building structural components such as walls, roof, HVAC, plumbing, electrical, QIP,[v] and, generally, land improvements[vi]).

HOLDING PERIOD → To simplify our analysis in this Primer, we will assume that the Property and all its components ***are held for over one year***, and thus any capital gain will be treated as long-term capital gain.

3 Recapture

The benefit of depreciation is not absolute. If the Property, or any component thereof, is eventually sold for more than its depreciated value – that is, its Adjusted Basis – the depreciation recovered in this manner is treated as taxable income. This process is known as **depreciation recapture**.[vii]

Step 1: Allocate Sales Price

When Property is sold, the taxpayer must calculate the gain realized on each component of which the Property was comprised. Whether the taxpayer only separates the Property between land and improvements *or* has maximized depreciation by carefully segregating the Property into numerous asset categories, the first step after a sale is to allocate the amount realized (Amount Realized)[viii] across the various components comprising the Property:

- The total Amount Realized is allocated in proportion to the assets' respective fair market values. If an allocation is made in an arm's length purchase contract, that allocation is generally respected.
- This allocation will then determine the gain on sale on an asset-by-asset basis—how much is §1245 recapture, how much is §1250 recapture, how much is unrecaptured §1250 gain, and how much is §1231 gain—as described below.

Step 2: Calculate & Categorize Gain

Step 2.1 – Calculate Component's Gain

Under IRC §1001(a), gain from a sale or exchange (Gain) is the Amount Realized minus Adjusted Basis, ***computed component by component*** (i.e., the Amount Realized allocated to each component under Step 1, minus the Adjusted Basis of component under Section 2).

Component's Amount Realized − **Component's Adjusted Basis** = **Component's Gain**

Step 2.2 – Classify Parts of Component's Gain

Gain itself is comprised of 2 parts, Gain attributable to depreciation taken (Depreciation Gain) and Gain attributable to appreciation in value (Section 1231 Gain), determined as follows:

Component's §1231 Gain = **Component's Amount Realized** − **Component's Original Basis**

Component's Depreciation Gain	=	Component's Original Basis	–	Component's Adjusted Basis

Step 2.3 – Classify §1250 Depreciation Gain

Lastly, for §1250 property, Depreciation Gain itself is comprised of 2 parts: "additional depreciation"[ix] and "unrecaptured §1250 gain", calculated as follows:

Additional Depreciation	=	Component's Accumulated Depreciation (Actual)	–	Component's Accumulated Straight-Line Depreciation (Would-Be)

Unrecaptured §1250 Gain	=	Component's Depreciation Gain	–	Additional Depreciation

Step 3: Calculate Tax

Now, possessed with the character and amounts of all Gain, the taxpayer can determine the amount of tax payable as a result of its Property-sale, based on the taxpayer's applicable marginal tax rate in each tax category:

Recapture

- Depreciation Gain on §1245 property - under §1245(a), recaptured as ordinary income (taxed at taxpayer's marginal rate; up to 37%).
- Additional depreciation (part of Depreciation Gain on §1250 property) - under §1250(a), recaptured as ordinary income (taxed at taxpayer's marginal rate; up to 37%).

Capital Gain

- Unrecaptured §1250 gain (part of Depreciation Gain on §1250 property) - under §1(h)(6)(A), recaptured as a special category of capital gain (taxed at lower of (i) taxpayer's marginal ordinary income tax rate, and (ii) 25%).

This category ⬆ represents recovery of amounts previously depreciated, so in many ways should be viewed as recapture; however, the IRS treats this as a special category of capital gain.

- Section 1231 Gain - treated as long-term capital gain (taxed at 20%).

[i] This Primer addresses U.S. Federal income tax rules, and all section references are to the Internal Revenue Code (Title 26 of the U.S. Code); State of California income tax rules are largely comparable, outside of tax rates, with certain exceptions (e.g., non-conformance with bonus depreciation of 20-year and under property under §168(k) and, importantly to the context of this Primer, the State's non-conformance to Qualified Opportunity Zone tax deferral benefits).

[ii] IRC §167(a).

[iii] IRC §168; see Table A.

[iv] Under IRC §1016(a)(2) and Treas. Reg. §1.1016-3, taxpayers are technically *required* to reduce their basis by the greater of the depreciation deduction to which they are entitled (what was "allowable") and the amount the IRS actually permitted the taxpayer to claim (what was "allowed"); thus the IRS is *telling* taxpayers to take the largest permitted deductions. As a practical matter, the IRS will likely tolerate this error, but failing to take the largest available deduction will not only cost the taxpayer in the short-term, but the IRC requires the taxpayer to recapture depreciation on the basis of the full allowable deductions even if a lesser amount was in fact taken. This harsh rule has an important exception, however: if the taxpayer has adequate supporting documentation of its allowed deductions, recapture will be limited to such amount (IRC §§ 1245(a)(2)(B) & 1250(b)(3)).

[v] Qualified improvement property. Qualified Improvement Property (QIP) is any improvement made by a taxpayer to an interior portion of a nonresidential (commercial) building after the building is first placed in service. IRC §168(e)(6).

[vi] Land improvements are permanent additions to land that make it usable or more valuable but are separate from the building itself (e.g., paving and parking lots, driveways and sidewalks, fencing, landscaping, exterior lighting, retaining walls, drainage systems, and utility connections). IRC §168(e)(1).

[vii] Depreciation deductions reduce ordinary income, taxed at the highest rate, so if depreciation recapture was taxed at the lower (much, in some cases) capital gain rate, the result would be a gap that disfavors the IRS. The IRC closes most of that gap by recharacterizing the part of your gain that comes from depreciation, so it's taxed as ordinary income or at a special 25% rate. How much of the gain is affected, and at what rate, depends on **what kind of property** was depreciated and **how fast** it was depreciated.

[viii] Amount Realized is the total value a seller receives in a sale or exchange – cash plus the fair market value of any other property received. IRC §1001(b).

[ix] Additional depreciation can disappear if property is held long enough that the straight-line depreciation method would have fully-depreciated the Original Basis of an asset.

TABLE A
DEPRECIATION METHODS BY ASSET CLASS & SPECIAL RULES

IRC §168 (MACRS) assigns every asset class a default recovery period and method:

Asset class	Real estate examples	Recovery period	Method
5- and 7-year property	Appliances, carpet, furniture, equipment	5 or 7 years	200% declining-balance*
15-year land improvements	Paving, landscaping, site utilities, fencing	15 years	150% declining-balance*
Qualified improvement property	Interior improvements to a commercial building	15 years	Straight-line
Residential rental property	Apartment buildings, rental houses	27.5 years	Straight-line
Nonresidential real property	Office, retail and industrial buildings	39 years	Straight-line

* Declining-balance methods switch to straight-line when that gives a larger deduction.

Special rules can change the defaults:

Bonus depreciation
§168(k). Since 2025 law, automatic deduction of 100% of qualifying property (property with a recovery period of 20 years or less) in year one unless taxpayer elects out.

§179 expensing
An election to expense qualifying property, including certain roofs, HVAC and security systems. Subject to dollar and income limits.

Straight-line election
§168(b)(5). Elect straight-line for an entire asset class placed in service that year.

Alternative system (ADS)
§168(g). Straight-line over longer periods. Required in some cases and elective in others; no bonus.