



Issue Fact Sheet

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CAPITAL GAINS AND DEPRECIATION RECAPTURE

Background

Present federal tax laws discourage investment in new apartment properties and modernization of older apartment communities. The combination of capital gains taxes coupled with a depreciation recapture rate of 25 percent and a composite depreciation life of 27.5 years for both new and used apartment investment have led to a steady decline in the number of apartment units necessary to meet demand.

Additional Points:

- Older apartment properties are in need of rehabilitation and modernization. Many of these properties cannot be sold to potential investors who are willing to spend the monies needed for repair and modernization because the existing owners are locked-in by what the effect of capital gains taxes would be in the event of sale.
- In 1997, a change in federal tax law brought in a new concept called "depreciation recapture." Under this new concept, all previously-taken depreciation is now subject to a recapture tax rate of 25 percent. This concept fails to recognize that properties do wear out and depreciation is recognition of this wearing-out process. For commercial properties, depreciation is a natural cost phenomenon -- not some "tax benefit" that needs to be recaptured.
- In 1999, Congress recognized that recapture was not necessarily a good idea and coupled a reduction in capital gains rates with a reduction in depreciation recapture rates. This legislation was later vetoed.
- Apartment property assets have various useful lives. Many components of an apartment wear out physically or economically in a much shorter time frame than 27.5 years. However, the current law requires that an investment in a new or used apartment be written off over a 27.5 year period on a straight-line basis. This neither reflects the cost of money or the actual composite life of an apartment property.
- Nationwide, the annual turnover rate of residents is approximately 50 percent and for some properties approaches 100 percent. This constant flux of residents has a greatly deteriorating effect on the life of various components within an apartment.
- Many garden-style apartments wear out in less than 27.5 years while the basic high-rise structure might last longer. As much as 50 percent or more of the value of an entire apartment property is made up of components that have a useful life of 15 years or less and some have a life of only five years.
- Components that last no longer than four to seven years include carpeting, linoleum, kitchen appliances, and some fixtures.
- Roofs, piping, air conditioning units, boilers, decks, and some electrical systems have a life of no longer than 15 years.
- Changes in safety codes, environmental laws, and handicapped regulations also have led to expenditures to replace or modernize systems.
- A paper titled "Depreciation and the Taxation of Real Estate," written by Dr. Jane Gravelle of the Congressional Research Service in May 1999 stated that "depreciation on residential structures is more restrictive than it has been since 1971." As a result, "tax burdens on structures are higher than those on equipment" and "the gap between the two has widened" since the 1986 tax reform legislation.

NMHC/NAA Position

NMHC strongly supports tax legislation which decreases both capital gains taxes and depreciation recapture rates. In addition, recent surveys show that the present-law depreciation rate of 27.5 years is too long and does not reflect eco-

conomic reality.

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