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Depreciating your 1031 replacement property

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Just in case the state of the market and credit crunch is not enough to worry about for buyers of investment property, let's discuss another topic worthy of consideration applicable to 1031 exchange buyers when selecting replacement property. What portion of the cost of the replacement property is available for depreciation by a 1031 buyer ? And why does it matter?

Of course it matters since the ability to depreciate property over the useful life of an asset has an effect on the amount of income tax owed and thus can affect cash flow in a significant way.

When buying real property, understanding the annual tax consequences of ownership are essential to accurately analyzing the benefits for any investor. So if you are a broker assisting a client in locating prudent investment property and are performing cash flow and other analysis with respect to various properties and making recommendations, read on. To answer the question of what portion of the replacement property cost is depreciable we must first understand the concept of replacement property basis in a 1031 exchange. Typically, the basis of new property is its purchase price. In a 1031 exchange, this is not the case because the investor is deferring capital gain. In a 1031 exchange, the basis of the replacement property is generally referred to as a carry over basis. Roughly speaking, the basis of replacement property is its purchase price less the capital gain deferred plus any additional cash used to acquire the property.

Thus, where an investor buys property of roughly equal value to the relinquished property, the basis of the replacement property will be the basis of the relinquished property on the date of sale, which is why the replacement property is generally known to have a "carry over" basis in a a 1031 exchange .

Once the basis of replacement property is determined, investors must then distinguish between "exchanged basis" and "excess basis." "Exchanged basis" is the remaining basis of the relinquished property carried over to the replacement property and "excess basis" is the additional consideration used to acquire the replacement property that exceeds the value of the relinquished property (T.D. 9314). With respect to each the exchanged basis and the excess basis, investors must then determine the recovery period and the depreciation method applicable to such basis. Under the regulations, the recovery period applicable to each may differ.

The regulations require that the replacement property exchanged basis be depreciated over the remaining recovery period of the relinquished property using the same method of depreciation unless the recovery period of the replacement property is longer. If the recovery period of the replacement property is longer than the recovery period of the relinquished property, the remaining recovery period of the exchanged basis must be recalculated using the longer recovery period.

Thus, if an investor sells an office building that was depreciable over 39 years and buys a rental apartment building depreciable over 27.5 years, any remaining exchanged basis must be depreciated using the longer 39 year recovery period. If, instead, the investor had sold a rental apartment building and purchased an office building, any remaining exchanged basis must be depreciated using the longer 39 year recovery period applicable to the replacement property. Fortunately, the regulations provide that excess basis is depreciated the same as property acquired outside of an exchange. Thus, the recovery period and depreciation method are both determined as they would be on new property.

If, for instance, an office building is sold and a rental apartment purchased, any excess basis is depreciated over the period applicable to the rental apartment building as of the date it is placed in service by the investor. Under current regulations, this would allow the investor to depreciate the excess basis over 27.5 years. Importantly, the regulations allow investors to elect out of the structure therein. The election must be timely made (by the due date of the investor's return including extensions for the year in which the replacment property is acquired) but if timely made allows an investor to treat both the exchanged basis and the excess basis as if they are placed in service as of the date of the acquisition of the replacement property.

This allows an investor to use the same recovery period and depreciation method for the exchanged as is used for the excess basis, thereby simplifying required accounting for such assets.

Note that in cases where an investor trades into replacement property of roughly the same value as that sold and where the relinquished property has been fully or almost fully depreciated as of the date of sale, the investor will not benefit from additional depreciation on the replacement property. Thus, whereÂ§1031 replacement property is involved, the financial analysis of the property's cash flow and its returns differs from the standard manner in which properties are analyzed generally. Both investors and brokers performing such analysis on behalf of clients need to be aware of these consequences to ensure that pro formas are accurate. Where depreciation provides significant benefits to an investor where no Â§1031 exchange is being performed, this may not be the case where an exchange is being performed. Thus, while a property might appear to be a very attractive investment, it may not so appear in the Â§1031 context since these benefits may be reduced or eliminated entirely where a Â§1031 exchange is being performed. Care should be taken to ensure that such benefits are not presumed applicable in a Â§1031 transaction and that any financial analysis performed on any particular property takes into account the basis and depreciation rules and limitations discussed above.

Pamela A. Michaels is an attorney and Vice President of Asset Preservation, Inc., a nationwide Qualified Intermediary and wholly owned subsidiary of Stewart Title. Asset Preservation, Inc. has performed more than 120,000 exchanges in its sixteen year history and performs all types of exchanges. Ms. Michaels is located in Manhattan and can be reached at 866-317-1031 or at pmichaels@apiexchange.com.