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Depreciation of 1031Replacement Property

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When a taxpayer completes an exchange, we are often asked how to figure the depreciation on the new replacement property. What if one property is exchanged for two properties? Some taxpayers think the starting basis in the 1031 replacement property is what they paid for it. Unfortunately, that is not correct, and for some folks this is shocking news. The total new starting basis in the replacement property is what the replacement property cost less the gain deferred in the exchange.

Let's say our taxpayer purchased a rental property ten years ago for $500,000. While repairs were made, no depreciable improvements were made to the property. The taxpayer took $150,000 in depreciation over the ten year period. The adjusted basis for the relinquished property is now $350,000. If the relinquished property is sold for $1 million and the taxpayer has selling and exchange expenses of $80,000, the taxpayer's realized gain would be $1 million less the adjusted basis of $350,000 and less exchange expenses of $80,000, for $570,000 of realized gain.

If the taxpayer meets the 1031 reinvestment requirements and purchases replacement property of say $1.2 million, the total new basis for the replacement property received would be $630,000. This total new basis is computed by taking the $1.2 million cost of the new property and subtracting the $570,000 of gain deferred in the exchange. When an exchange is completed, an IRS Form 8824 is filed with the IRS along with your tax return for the year the relinquished property was transferred. The new total replacement property basis will be shown on Line 25 of the form and is labeled "Basis of like-kind property received."

New IRS Rules. In January 2000 IRS Notice 2000-4 described the way a new replacement property was to be depreciated. Then in early 2004 the IRS published in T.D. 9115 detailed temporary and proposed regulations for figuring replacement property depreciation. Under the new Temporary Regulation Section 1.168(i)-6T, the general rule remains that the taxpayer must depreciate the remaining relinquished property's adjusted basis (called the exchanged basis) over the remaining recovery period using the same depreciation method as if it were a continuation of the relinquished property depreciation schedule.

To develop the replacement property depreciation schedules, the Temporary Regulations split the new total basis of the replacement property between the “exchanged basis” and the “excess basis.” The exchanged basis is the remaining basis carried over from the relinquished property. The excess basis is the resulting increase in basis from the taxpayer’s trading up in value.

The excess basis will be treated as newly acquired property and will be depreciated over 27.5 years for residential property or over 39 years for nonresidential real property using a new straight line depreciation schedule. No depreciation may be claimed for the period between the transfer of the relinquished property and the receipt of the replacement property.

Example: Using our numbers above, a taxpayer has been taking depreciation for 10 years on a residential rental purchased for $500,000. He has taken $150,000 in total depreciation, leaving an adjusted basis of $350,000. The residential rental property purchased for $1.2 million has a new starting basis after the exchange of $630,000. Of this $630,000, the remaining carried over exchanged basis is $350,000, and the excess basis is $280,000.

The two depreciation schedules for the replacement property would be (1) continuation of the original relinquished property schedule for the remaining 17.5 years, and (2)a new schedule to cover the increase in value reflected in the excess basis. If the depreciable improvements were deemed 80% of the full value of the replacement property, then 80% of the excess basis of $280,000 would be depreciated over 27.5 years.

Elect-out of Using New Rules. The new regulation does permit the taxpayer to elect-out of the rules and to treat the entire replacement property as a new asset. To make the election to not use the new rules, see the instructions for IRS Form 4562, Depreciation and Amortization at www.irs.gov. The election is made on IRS Form 4562 with your on-time tax return for the year the replacement property is received. Also, the 2004 regulations do not address how the depreciation rules work with exchanges of multiple replacement properties. The simplest approach would be to elect out of using the new rules and depreciate each property using a new depreciation schedule. The starting basis for the individual multiple replacement properties is the ratio of its value to the total value of all the replacement properties multiplied against the total new basis for all the replacement properties as reported on Form 8824.

Longer Recovery Period. What if the replacement property has a longer recovery period as in the exchange of residential rental property for a commercial property with a 39 year recovery period? Instead of the relinquished property depreciation allowance continuing as in our example for 17.5 years, the remaining amount of the exchanged basis to be depreciated would be spread out over the longer recovery period of 29 years (39 years minus 10 years). Unfortunately, the reverse is not true. If the exchange was from commercial to residential, the longer relinquished property depreciation schedule would continue to be used.

This article can only provide the basics for developing 1031 replacement property depreciation schedules. Taxpayers should consult with their tax advisors and CPAs.

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