

Favorable Depreciation Rule. In Notice 2000-4 the IRS has favorably changed the way a new replacement property is to be depreciated. For most properties this will result in a faster cost recovery of depreciation. Previously, replacement property real estate was treated as newly purchased property with an adjusted basis and was depreciated over 27.5 or 39 years using a new straight line depreciation schedule.

Now, for MACRS replacement property placed in service after January 2, 2000, the balance of the old depreciation remaining on the relinquished property(ies) will be taken on the new replacement property by continuing to use the old depreciation schedule.

Example: An exchangor has been taking depreciation for 10 years on a residential rental with \$150,000 of depreciable improvements. Each year he took \$5,454 of straight line depreciation ($\$150,000 \div 27.5$) for a total of \$54,545.

Now he will continue to depreciate the new replacement property by \$5,454 per year for the next 17.5 years until the \$95,445 remaining depreciation is taken ($\$150,000 - 54,545$), while at the same time he will take depreciation on the balance of the replacement property depreciable improvements above the \$95,445 carried forward using a new 27.5 or 39 year schedule.

For exchangors changing from a residential to a commercial property this can be a significant increase in the annual depreciation claimed.

How to Handle the Earnest Money Deposit on the Replacement Property. Since it is custom that the exchangor/purchaser give some type of earnest money deposit when they make a contract offer on the replacement property – the question how to handle the deposit comes up in almost every exchange. Three common situations are:

First, if the exchangor is going to have to bring cash to the settlement, over and above the amount in escrow, then the exchangor should make the deposit and have that amount credited at settlement toward purchase of the replacement property.

Second, when the contract on the replacement property is written before the closing on the relinquished property obviously the exchangor must make the deposit with the contract offer. Later, if desired, after the closing of the relinquished property, the Qualified Intermediary may substitute the cash deposit.

Third, when the replacement property contract is written after the Qualified Intermediary is holding the escrow funds the exchangor has four options --

- (1) make a cash deposit and let it ride toward the purchase price.
- (2) make the required cash deposit and request the Qualified Intermediary replace it with a substitute deposit.
- (3) make a small cash deposit and agree in the contract for an additional deposit to be made by the Qualified Intermediary in 7 to 10 working days.
- (4) give the seller a promissory note with the provision that the Qualified Intermediary will pay if off within 7 to 10 working days after ratification of the contract. If the Qualified Intermediary is to replace the deposit, add to the deposit, or payoff the Note then the following must happen:
 - (1) a copy of the contract must be provided to the Qualified Intermediary
 - (2) the Qualified Intermediary prepares the Assignment of Replacement Property Contract and it is signed and returned to the Qualified Intermediary by the Exchangor.
 - (3) the Qualified Intermediary forwards the required deposit to the party named in the contract and request if applicable the deposit made by the exchangor be returned to them.

Tax wise it makes no difference if the exchangor makes a cash deposit and then after settlement of the final replacement property receives that amount in cash from the settlement agent or the Qualified Intermediary. Because - in an exchange - 'cash in offsets cash out'.

Most Important — no deposit may be made by the Qualified Intermediary until the exchangor's interest in the contract is assigned by the exchangor to the Qualified Intermediary.

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Have a question? Need an answer?

Contact: edhoran@exchangerealestate.com
or call - Ed Horan or Cindy Dove at **800-795-0769**
3501 Delashmutt Drive, Haymarket, VA 20169

