



Summer 2002 Exchange News

Advanced Rent and Deposits. When a rental property is sold the owner owes the purchaser any rent and deposits that have been collected in advance. These payments should be made outside of closing. If proceeds from the closing are used to make these payments they will be considered "cash boot" and result in recognized capital gain.

Is it a Repair or Improvement? In Publication 527 the IRS defines a repair as keeping the property in good operating condition. A repair does not materially add to the value of the property, or substantially prolong its life. While an improvement adds to the value of the property, prolongs its useful life, or adopts it to new uses. Publication 527 provides some examples of an improvement.

The cost of an improvement must be capitalized (depreciated). For a residential rental property this means it will take 27.5 years to recover the cost of the improvement. Whereas a repair cost is shown on IRS Form 1040, Schedule E and immediately offsets rental or other income for that year. If you sell the property, all the depreciation you have taken gets recaptured and taxed at 25%. Repair costs are not recaptured or taxed. Of course if you do an exchange the depreciation portion of your capital gain gets deferred along with the profit.

Is a Fix-up Expense a Selling Cost or a Repair? Owners often ask if repairs made to a house to get it ready for sale can be claimed as a selling cost. We recommend that these expenses be claimed as repairs on your Schedule E and not as selling costs. If you claim them as a selling costs, like the real estate agent's commission, then in an exchange the result is to lower the amount of capital gain that is already being deferred. So there is no immediate economic gain. Whereas, if they are claimed as repair expenses on your Schedule E they immediately offset rent received or other income.

For a free copy of Publication 527, "Residential Rental Property (Including Rental of Vacation Homes)" and a copy of Schedule E with Instructions call IRS publications at 1-800-829-3676.

Sales Contract Should Reflect Correct Owners/Buyers. A great deal of confusion and extra work occurs when the sales contract does not properly list the actual owner(s) of the property being sold, or the full name(s) of the buyers of the property. In an exchange, the parties in title on the relinquished property who wish to do an exchange **must take title to the replacement property using the same name(s) and tax I.D. number.** While there are minor exceptions to this rule, such as the use of a revocable trust, it is important that the exchangor discuss any proposed changes with their Qualified Intermediary and tax advisor.

Action!! Exchangors should make certain the correct names are on the sales contract.



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Lease to a Builder or Third Party. It has long been a restriction that improvements built on property already owned were not like kind. Thus such improvements did not qualify as like kind replacement property. However, since a lease of over thirty years is considered real estate it is possible for an exchangor to lease a lot to a builder or a non-related third party for a period in excess of thirty years with the stipulation that the lessee may build an improvement on the lot.

Then the exchangor may purchase the builder's leasehold interest along with the improvement as their replacement property. Some of the issues are: (1) the lease when given and when assigned back must have at least 30 years remaining, (2) the improvement must be purchased and the lease reassigned within the 180 days following transfer of the first relinquished property, and (3) only the value of the improvement will count towards the exchangor's reinvestment requirement.

Using a lease provides a method to do an exchange for an improvement on property already owned. It also avoids transfer taxes if the lot had to be sold to the builder and then repurchased with the improvement completed as the replacement property. If you are interested in using a lease in your exchange suggest you discuss it with your attorney. We can provide him or her with a sample of a lease that was used in an exchange that has already been completed.

This publication is designed to provide accurate information on tax deferred exchanges. The publisher is not engaged in rendering legal or accounting services. If legal or tax advise is required the services of a competent professional should be sought.

Have a question? Need an answer?

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