

Depreciation of Replacement Property Received in a Section 1031 Exchange

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Introduction

Put yourself in this situation. You are preparing a return for a client who exchanged one residential rental property for another residential rental property in a deferred §1031 exchange. You need to determine the allowable depreciation for the client's old property and the new property. Here are some of the questions that you have:

- When does depreciation end on the old relinquished property and begin on the new replacement property?
- Do you simply carry over the same basis of the old relinquished property and continue depreciating it, or do you start depreciating a different basis for the new replacement property?
- Since the client received depreciable property (building) and nondepreciable property (land) in the exchange, how do you allocate the basis of the new property to building and land?
- If some of the gain on the exchange is taxed due to "boot," how does this affect the basis of the new replacement property?
- What if multiple properties were acquired in the exchange? How do you determine their depreciable bases?

I will answer these questions in this article. I will also provide three examples.

General Principles

IRC §1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

IRC §1031(a)(3) provides that the properties need not be exchanged simultaneously. A like-kind exchange will qualify if the taxpayer identifies the replacement property within 45 days after the date on which the taxpayer transfers the relinquished property, and if the taxpayer receives the replacement property within 180 days after such date (or the earlier due date of the return for the year of the exchange).

Here are some general principles that will help you determine the depreciable basis of the replacement property:

1. Basis of replacement property is often higher than the basis of the relinquished property.

In an IRC §1031 exchange, the basis of the replacement property is equal to the basis of the relinquished property, minus money received, minus debt relief, plus the gain recognized, plus additional consideration given.¹ In most §1031 exchanges, this will be higher than the adjusted basis of the relinquished property due to additional money that the taxpayer pays or a higher mortgage loan on the replacement property.

2. Basis of replacement property must be split into "exchanged basis" and "excess basis."

If the basis of the replacement property is higher than the basis of the relinquished property, then it will have to be split into two parts known as "exchanged basis" and "excess basis," each of which is depreciated separately. "Exchanged basis" is the adjusted basis of the relinquished property, and "excess basis" is the basis of the replacement property that exceeds the "exchanged basis."²

3. Depreciate the "exchanged basis" over the remaining recovery period.

If the depreciation method and recovery period of the relinquished and replacement properties are the same, then the "exchanged basis" of the replacement property must be depreciated using the same method over the remaining recovery period of the relinquished property.³ For example, if both properties are residential rentals, which are depreciated as 27.5-year Modified Accelerated Cost Recovery System (MACRS) properties, and if the relinquished property had been depreciated for seven years before the year of the exchange, then the "exchanged basis" of the replacement property is depreciated as MACRS property using a 20.5-year recovery period. The remaining recovery period is determined as of the first day of the year in which the relinquished property is disposed of.⁴

If the recovery period of the replacement property is different from the recovery period of the relinquished property, then the "exchanged basis" of the replacement property must be depreciated over the remainder of the longer of the two recovery periods.⁵ For example, if the relinquished property is a residential rental (27.5-year MACRS property)

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and the replacement property is a non-residential rental (39-year MACRS property), and if the relinquished property had been depreciated for seven years before the year of the exchange, then the “exchanged basis” of the replacement property is depreciated as MACRS property using a 32-year recovery period.

4. Depreciate the “excess basis” as newly-acquired property.

If the basis of the replacement property is higher than the basis of the relinquished property, then there will be “excess basis.” This “excess basis” is depreciated as newly-acquired property.⁶

5. No depreciation between disposition and acquisition dates.

In a deferred exchange where the relinquished property is disposed of first, and there’s a period of time before the replacement property is acquired, no depreciation is allowable between the date that the relinquished property is disposed of and the date that the replacement property is acquired.⁷

The disposition and acquisition occur when the burdens and benefits of ownership have passed, which is usually when the qualified intermediary has disposed of the relinquished property and acquired the replacement property, rather than when the properties are transferred to and from the taxpayer.⁸

6. Allocate building and land based on replacement property values.

If the replacement property includes land (or other non-depreciable property), then both the “exchanged basis” and “excess basis” must be allocated to land and building.⁹ The allocation is made based on the land and building values of the replacement property.¹⁰ This means that you can’t just continue depreciating the old property as if it were the “exchanged basis” because you will need to make a new building and land allocation.

7. Allocate basis to multiple replacement properties based on their values.

If more than one replacement property is acquired in the exchange, then both the “exchanged basis” and “excess basis” must be allocated to each replacement property based on their values.¹¹ The “exchanged basis” and “excess basis” of each replacement property must also be allocated to building and land based on the building and land values of each replacement property.

8. Consider election to treat replacement property as newly-acquired property.

It may be disadvantageous for a taxpayer to allocate the basis of the replacement property between “exchanged basis” and “excess basis,” such as when the MACRS recovery periods of the relinquished and replacement properties are different.

For example, if the relinquished property is a non-residential rental (39-year MACRS property) and the replacement property is a residential rental (27.5-year MACRS property), and if the relinquished property had been depreciated for seven years before the year of the exchange, then the “exchanged basis” of the replacement property would have to be depreciated as MACRS property using a 32-year recovery period.¹²

In such a situation, the taxpayer may elect to depreciate the replacement property as newly-acquired property.¹³ The election must be made by the due date of the return, including extension, for the year in which the replacement property was acquired.¹⁴ The election is made by attaching a statement to the return that specifies the property or properties to which the election applies.¹⁵

In the example above, the election would allow the taxpayer to depreciate the replacement property using a 27.5-year recovery period instead of a 32-year recovery period.

What if the taxpayer was unaware of the requirement to split the basis of the replacement property between “exchanged basis” and “excess basis” and to depreciate the “exchanged basis” over a shorter recovery period? Instead, the taxpayer depreciated the replacement property as newly-acquired property, without making the election as described above. As a result, the taxpayer missed out on larger depreciation deductions for the “exchanged basis.” How can this situation be corrected?

In my opinion, since the election was not made, the depreciation should be corrected on future years’ returns, and amended returns should be filed for all affected years for which the statute of limitations has not expired. The regulations indicate that the missed depreciation in “closed years” can’t be claimed as a change in method of accounting.¹⁶

Examples

Example 1 – Deferred exchange, no boot, single property exchanged for single property

Arthur exchanged his residential rental property on Diamond Lane for a new residential rental property on Ruby Street. He bought the Diamond Lane property seven years ago for \$400,000 and took depreciation totaling \$64,000, resulting in an adjusted basis of \$336,000. At the time of the exchange, the mortgage loan had a principal balance of \$300,000.

On January 20, 2017, Arthur transferred the Diamond Lane property to a qualified intermediary, who sold it immediately for \$550,000. Selling expenses, such as commissions, title insurance, and the exchange fee, totaled \$45,000. On January 25, Arthur identified the Ruby Street property as the replacement property, and on March 10, the intermediary purchased it for \$650,000. Closing costs were \$5,000. The new mortgage loan on the Ruby Street property was \$450,000.

The intermediary’s sale of the Diamond Lane property resulted in net proceeds of \$205,000 (\$550,000 sales price

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minus \$45,000 selling expenses minus \$300,000 loan payoff). All of the proceeds were used to purchase the Ruby Street property. There is no “boot” because Arthur didn’t receive any proceeds and the debt on the Ruby Street property (\$450,000) was more than the debt relieved of on the Diamond Lane property (\$300,000).

Since no gain is recognized on the exchange, the basis of the Ruby Street property is \$486,000, which is the \$336,000 adjusted basis of the Diamond Lane property plus the additional mortgage loan of \$150,000 (\$450,000 vs. \$300,000). \$336,000 is “exchanged basis,” and \$150,000 is “excess basis.”

Both the “exchanged basis” and “excess basis” must be allocated to building and land based on the building and land values of the Ruby Street property. According to the tax assessor’s valuation, the building/land allocation is 60 percent/40 percent. Therefore, the “exchanged basis” allocated to the building is \$201,600 (\$336,000 x 60 percent), and the “excess basis” allocated to the building is \$90,000 (\$150,000 x 60 percent).

Arthur gets a half-month depreciation for the Diamond Lane property since it was disposed in January 2017. For the “exchanged basis” of the Ruby Street property, Arthur’s depreciation is calculated using the remaining recovery period of 20.5 years (27.5 years minus seven years of depreciation for the Diamond Lane property). For the “excess basis” of the Ruby Street property, Arthur’s depreciation is calculated using a recovery period of 27.5 years.

As a result, Arthur gets \$10,376 depreciation for the Ruby Street property, computed as follows:

| Exchanged Basis | |
|--|-----------|
| Basis Allocated to Building | \$201,600 |
| MACRS Rate for Remaining Recovery Period (1/20.5) | .04878 |
| Annual Depreciation | \$9,834 |
| Percentage for # of Months (Mid-Month Convention) (9.5/12) | .7917 |
| 2017 Depreciation | \$7,785 |

| Excess Basis | |
|---|----------|
| Basis Allocated to Building | \$90,000 |
| MACRS Factor for Placed in Service in 3rd Month | .02879 |
| 2017 Depreciation | \$2,591 |

Example 2 – Deferred exchange with boot, single property exchanged for single property

Assume the same facts as *Example 1*, except that Arthur received \$50,000 of the proceeds from the sale of the Diamond Lane property, and that the new mortgage loan on the Ruby Street property was \$500,000. Arthur must report a \$50,000 gain on the exchange.

The basis of the Ruby Street property is \$536,000, which is the \$336,000 adjusted basis of the Diamond Lane property, minus the \$50,000 money received, plus the \$50,000 gain recognized, plus the additional mortgage loan of \$200,000 (\$500,000 vs. \$300,000). \$336,000 is “exchanged basis,” and \$200,000 is “excess basis.”

The “exchanged basis” allocated to the building is \$201,600 (\$336,000 x 60 percent), and the “excess basis” allocated to the building is \$120,000 (\$200,000 x 60 percent).

Arthur gets a half-month depreciation for the Diamond Lane property since it was disposed in January 2017. He gets \$11,240 depreciation for the Ruby Street property, computed as follows:

| Exchanged Basis | |
|--|-----------|
| Basis Allocated to Building | \$201,600 |
| MACRS Rate for Remaining Recovery Period (1/20.5) | .04878 |
| Annual Depreciation | \$9,834 |
| Percentage for # of Months (Mid-Month Convention) (9.5/12) | .7917 |
| 2017 Depreciation | \$7,785 |

| Excess Basis | |
|---|-----------|
| Basis Allocated to Building | \$120,000 |
| MACRS Factor for Placed in Service in 3rd Month | .02879 |
| 2017 Depreciation | \$3,455 |

Example 3 – Deferred exchange, no boot, single property exchanged for two properties

Assume the same facts as *Example 1*, except that on January 25, Arthur identified the Emerald Way and Sapphire Court properties as the replacement properties, and on March 10, the intermediary purchased them for \$300,000 and \$350,000, respectively. Closing costs were \$2,000 and \$3,000, respectively. The new mortgage loans on the Emerald Way and Sapphire Court properties were \$200,000 and \$250,000, respectively.

Since no gain is recognized on the exchange, the basis of the Emerald Way and Sapphire Court properties, combined, is \$486,000, which is the \$336,000 adjusted basis of the Diamond Lane property plus the additional mortgage loans totaling \$150,000. \$336,000 is “exchanged basis,” and \$150,000 is “excess basis.”

Both the “exchanged basis” and “excess basis” must be allocated to the Emerald Way and Sapphire Court properties based on their respective values. In addition, the “exchanged basis” and “excess basis” for each of these properties must be allocated to building and land based on their separate building and land values. According to the tax assessor’s valuation, the building/land allocation of the Emerald Way property was 65 percent/35 percent, and the building/land allocation of the Sapphire Court property was 70 percent/30 percent. Here are the results of the allocations:

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| Emerald Way Property | Exchanged Basis | Excess Basis |
|---|------------------|-----------------|
| Total Basis (\$486,000) | \$336,000 | \$150,000 |
| Portion Allocated to Emerald Way Property (\$300,000 / \$650,000) | .46154 | .46154 |
| Total Basis Allocated to Emerald Way Property | \$155,077 | \$69,231 |
| Portion Allocated to Building | 65% | 65% |
| Exchanged and Excess Basis Allocated to Building | \$100,800 | \$45,000 |

| Sapphire Court Property | Exchanged Basis | Excess Basis |
|--|------------------|-----------------|
| Total Basis (\$486,000) | \$336,000 | \$150,000 |
| Portion Allocated to Sapphire Court Property (\$350,000 / \$650,000) | .53846 | .53846 |
| Total Basis Allocated to Sapphire Court Property | \$180,923 | \$80,769 |
| Portion Allocated to Building | 70% | 70% |
| Exchanged and Excess Basis Allocated to Building | \$126,646 | \$56,538 |

Arthur gets a half-month depreciation for the Diamond Lane property since it was disposed in January 2017. For the “exchanged basis” of the Emerald Way and Sapphire Court properties, Arthur’s depreciation is calculated using the remaining recovery period of 20.5 years (27.5 years minus seven years of depreciation for the Diamond Lane property). For the “excess basis” of the Emerald Way and Sapphire Court properties, Arthur’s depreciation is calculated using a new recovery period of 27.5 years. As a result, Arthur gets \$11,707 depreciation on the Emerald Way and Sapphire Court properties, computed as follows:

| Emerald Way Property | Exchanged Basis |
|--|-----------------|
| Basis Allocated to Building | \$100,800 |
| MACRS Rate for Remaining Recovery Period (1/20.5) | .04878 |
| Annual Depreciation | \$4,917 |
| Percentage for # of Months (Mid-Month Convention) (9.5/12) | .7917 |
| 2017 Depreciation | \$3,893 |

| Emerald Way Property | Excess Basis |
|---|----------------|
| Basis Allocated to Building | \$45,000 |
| MACRS Factor for Placed in Service in 3rd Month | .02879 |
| 2017 Depreciation | \$1,295 |

| Sapphire Court Property | Exchanged Basis |
|--|-----------------|
| Basis Allocated to Building | \$126,646 |
| MACRS Rate for Remaining Recovery Period (1/20.5) | .04878 |
| Annual Depreciation | \$6,178 |
| Percentage for # of Months (Mid-Month Convention) (9.5/12) | .7917 |
| 2017 Depreciation | \$4,891 |

| Sapphire Court Property | Excess Basis |
|---|----------------|
| Basis Allocated to Building | \$56,538 |
| MACRS Factor for Placed in Service in 3rd Month | .02879 |
| 2017 Depreciation | \$1,628 |

I’ve reviewed dozens of articles and treatises on §1031 exchanges, but rarely are the rules discussed for determining the depreciable basis of the replacement property. If they are discussed, often they’re wrong. I hope that this brief look into this topic is helpful for those of you who prepare returns involving these transactions.

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¹ IRC §1031(d); Treas. Reg. §1.1031(d)-1.

² Treas. Reg. §1.168(i)-6(b)(7) and (8).

³ Treas. Reg. §1.168(i)-6(c)(3)(ii).

⁴ Treas. Reg. §1.168(i)-6(c)(5)(v).

⁵ Treas. Reg. §1.168(i)-6(c)(4)(i) and (ii).

⁶ Treas. Reg. §1.168(i)-6(d)(1)(i).

⁷ Treas. Reg. §1.168(i)-6(c)(5)(iv).

⁸ The like-kind exchange rules of IRC §1031 are in many respects similar to the involuntary conversion rules of IRC §1033. The courts have ruled that for purposes of IRC §1033, a “purchase” occurs when the burdens and benefits of ownership pass to the taxpayer. See, e.g., *W. & B. Liquidating Corp. et al. v. Commissioner*, 71 T.C. 493 (1979); *Estate of Johnston v. Commissioner*, 51 T.C. 290 (1968), *aff’d.* by *Dettmers et al. v. Commissioner*, 430 F.2d 1019 (6th Cir. 1970).

⁹ Treas. Reg. §1.168(i)-6(d)(2)(i).

¹⁰ *Id.*; Treas. Reg. §1.1031(j)-1(c).

¹¹ *Id.*

¹² See footnote 5, *infra*.

¹³ Treas. Reg. §1.168(i)-6(i)(1).

¹⁴ Treas. Reg. §1.168(i)-6(j)(2).

¹⁵ Treas. Reg. §1.168(i)-6(j)(3) and Form 4562 instructions.

¹⁶ Treas. Reg. §1.168(i)-6(j)(1) and (4).