1031 Exchange Depreciation Options

The benefits of 1031 exchanges (and drawbacks) are well-known throughout the real estate investor community, but managing depreciation through the exchange is not as well understood and can be complicated. However, in working through the administrative headaches, individuals can maximize their
depreciation and increase their free cash flow. This article outlines understanding real estate cost basis through a 1031 exchange, the ways to depreciate real estate post 1031 exchange, and best practices when selecting a depreciation schedule through 1031 exchange.

Having been in the tax code for over 100 years, real estate investors have come to appreciate the value of a 1031 exchange to defer taxes on gains and depreciation recapture. Savvy investors have come to imbed this tax strategy into their process to lower the cost of capital and reliance on bank lending. Thus, increasing their returns. The benefits also creep through to the overall economy through the multiplier effect on other industries involved in real estate transactions and subsequent property improvements.

Understanding Real Estate Cost Basis Through a 1031 Exchange

When transacting real estate through a 1031 exchange, also known as a like kind exchange, depreciation becomes a bit more complex than transacting in a taxable manner. That is because the purpose of the 1031 exchange from its inception in the tax code ensures continuity of investment. Essentially, it should feel like a transaction never took place and, the original investment, along with its adjusted cost basis and depreciation schedule, should carry through to the new asset. If the replacement property costs more than the relinquished property, that cost will need to add to the adjusted cost basis for depreciation. An investor cannot restart a new 27.5-year depreciation schedule on the cost basis of the replacement asset after a 1031 exchange.

For example, an investor purchases a single-family residential property for $200,000, and 3-years later decides to sell the property for $250,000. In those three years, the investor took $22,000 in depreciation (this figure is rounded up slightly from actual deprecation for simplicity) for an adjusted cost basis of $178,000. The investor then must add the total depreciation ($22,000) to the gain ($50,000) to come up with their funds exposed to taxation through a taxable sale ($72,000). Since the investor intends to reposition their real estate holdings, they can defer taxation on the $72,000 through a 1031 exchange. The investor decides to purchase a new residential rental property in a rapidly changing neighborhood for $300,000. The new cost basis of investment must carry over from the original property. The increased value must be added and the cost basis of the new property is the non-depreciated amount from the original investment ($178,000) plus the price increase over the relinquished property ($50,000) for a total cost basis for the new property of $228,000.

There are two ways to depreciate real estate post 1031 Exchange

Post-1031 exchanges the tax code states that you must split depreciation into two separate schedules as the preferred method. However, investors can opt-out of two schedule depreciation and depreciate the calculated cost basis on a single schedule. The latter method is typically what real estate investors pursue due to its simplicity, but they are leaving significant cash flow benefits on the table over time and at scale.

Single Schedule Depreciation

In choosing to pursue single schedule depreciation, the investor is opting out of the preferred tax code method and added benefits of two schedule depreciation in the interest of simplicity. Depreciating through this method is simple as you take the new adjusted cost basis of the asset, $228,000 in the example, and divide by 27.5 years (39 years if it's a commercial property) to come up with the annual depreciation going forward.

Two Schedule Depreciation (also referred to as Step-in-the-Shoes Depreciation)

Two schedule or Step-in-the-Shoes depreciation is the tax code preferred method and has significant benefits to the investor if they can overcome the complexity. Any remaining depreciation from the relinquished property needs to continue on the original schedule through this method,

- In the example provided, the investor held the property for 3-years before the exchange and had an adjusted cost basis of $178,000. This remaining $178,000 would then continue to depreciate for the remaining 24.5 years on the original schedule of $7,273 annually.

- The cost basis of the replacement property remaining, will depreciate on a new and separate 27.5-year schedule. In the example provided, the added cost basis of the replacement property is $50,000.
    - The annual depreciation for this portion of the cost basis is $1,818 ($50,000 / 27.5).

Benefits of Two Schedule Depreciation or Step-in-the-Shoes

The benefits of the two schedules / Step-in-the-Shoes depreciation method are apparent when comparing the annual depreciation figures. Annual depreciation in this example for single schedule depreciation is $8,291. For two schedule depreciation, that figure grows to $9,091 or an $800 increase in tax shielding depreciation for the next 24.5 years. Now a cynic might state that the gain is only temporary as the higher depreciation shield disappears after 24.5 years in this example, that individual would not understand the time value of money (cash today is worth more than cash in the future), and the compounding benefits of leveraging Step-in-the-Shoes depreciation at scale.

Choosing a Depreciation Schedule through 1031 Exchange

The reason investors opt-out of the preferred method of two schedule depreciation through a 1031 exchange is it can get complex. The complexity only grows when you begin to add more properties to the portfolio and the number of transactions increases as years go on. With this added complexity of two schedule depreciation, there is an added benefit in a higher early tax shield on the investment. For investors who own large portfolios of assets, the cash flow benefit can be tremendous and serve as a finance source to continue to grow their investment portfolio. Balancing complexity with the higher return will be unique to each investor and they should consult their tax advisors before moving forward with either schedule.