



Breaking News in the Real Estate Industry

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It's Tax Time: Little Known Facts about Depreciation

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The tax consequence of a **1031 Exchange** (aka like-kind capital gains tax-deferred transaction) usually is more than just the 15 percent capital gains taxes associated with the Exchange. Investors should take into account the depreciation and depreciation recapture issues when evaluating the various Replacement Property options available. Depreciation recapture calculations are affected by the initial depreciation methods used, the date the investment property was placed into service, the type of investment property, and the depreciation methods allowed under applicable tax laws and regulations at the time the investment property was placed into service.

Generally speaking, in a 1031 Exchange depreciation is recaptured at a rate of 25 percent. Improved properties placed in service between 1981 and prior to 1986 may also be eligible for payment of the **excess** depreciation—if Accelerated Cost Recover System had been utilized by the taxpayer, the excess is the incremental amount of depreciation above the straight line that would have been used—at the ordinary income tax rate of the taxpayer (today may reach up to 35 percent) upon sale of the property.

Additionally, the accelerated treatment of certain structures and improvements to property, such as sidewalks, driveways, fencing, parking, and landscaping, that have been depreciated over 15 years, using 150 percent declining balance method may create **excess** depreciation, which is eligible and taxed at the ordinary income tax rate of the taxpayer (today may reach up to 35 percent) upon sales of the property. Given these depreciation issues, it is not unusual for tax liabilities to range between 25 to 35 percent of the appreciated value of the asset. Depending on the taxpayer's return, the **excess** depreciation may even trip the Alternative Minimum Tax thresholds!

A couple of final comments regarding depreciation—Exchangers interested in replacing improved property with raw land as part of a 1031 Exchange should note that the 25 percent depreciation recapture tax liability, if any, on the improved property is NOT deferred, but due and paid no later than the tax filing date. Other sections of the IRC affect the taxpayer's depreciation liability and their effects are beyond the scope of this newsletter, but should be considered and addressed by the Exchanger prior to initiating any 1031 Exchange.

NOTICE: THE INFORMATION CONTAINED ABOVE IS NOT TAX ADVICE. PURSUANT TO DEPARTMENT OF TREASURY CIRCULAR 230, THIS ELECTRONIC MAIL IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY THE RECIPIENT, FOR THE PURPOSES OF AVOIDING ANY FEDERAL TAX LIABILITY OR PENALTY WHICH MAY BE ASSERTED UNDER THE INTERNAL REVENUE CODE.

TICs are Pass Through Entities

A **tenant-in-common investment** (TIC) is structured as a pass-through entity. TICs are not real estate investment trusts, limited partnerships, joint ventures or other real estate programs. The taxpayer does not receive a 1099 or K1 at the end of the tax year, but instead receives an income statement and any other information requested by the taxpayer. Depreciation is calculated independently by each taxpayer. Consequently, the taxpayer may more adequately match the depreciation of the **Relinquished and Replacement property**, potentially lowering his/her recaptured depreciation tax liability. Keep in mind that TICs nor any other real estate investment, will offset the **excess** depreciation tax liability, if any, in an Exchange. 1031 Exchanges defer only capital gains tax and the recaptured depreciation tax liabilities. Ideally, taxpayers should consult their tax advisors prior to listing any property for sale.

Notice: As with any real estate investment, there are various risks including, but not limited to: loss of principal, variations in occupancy which may negatively impact cash flow, limited liquidity, and limits on management control of the property.

1031 Exchange Tips:

Refinancing Before or After the 1031 Exchange

Refinancing immediately prior to initiating or after completing a "like-kind" capital gains tax-deferred transaction (aka 1031 Exchange) may result in a taxable event to the taxpayer. Why? The Internal Revenue Service (IRS) may make the argument that the refinancing was just one step in many steps of the 1031 Exchange. Therefore, the loan proceeds should be taxable as **Boot** in the exchange. Ouch! In the event of an IRS audit, the taxpayer may prevail (although, there are no guarantees) if the taxpayer shows "economic substance" argument. For example: Was the refinancing completed for business reasons? Did the taxpayer attempt refinancing over a long period? At a minimum, industry experts advise refinancing before listing the property for sale; refinancing 6 or more months prior to or after the exchange; and document the refinancing of the loan and the sale or purchase of the property as separate transactions. A taxpayer should always consult their certified public accountant, financial or tax planner/consultant and/or attorney before initiating any 1031 exchange.

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1031 Advanced Realty Exchange Services

- ⇒ One-one-one consultation with investors and their attorneys or certified public accountants regarding the 1031 Exchange process
- ⇒ Access to a team of core professionals to assist the real estate investor with their exit strategies from appreciated
- ⇒ Locate a qualified intermediary
- ⇒ Access to quality institutional-grade properties and programs nationwide
- ⇒ Work within the 1031 Exchange time limit constraints
- ⇒ Locate Replacement property to complete the 1031 Exchange
- ⇒ Obtain essential information on potential replacement properties and programs, their benefits and risks and their respective sponsors
- ⇒ Evaluate the properties' and programs' private placement memorandum (PPM) with respect to financial projections, market conditions, tenants, leases, financing, legal structure and exit strategy
- ⇒ Analyze your investment goals and the property's suitability to your financial objectives
- ⇒ Follow-up and follow through the entire direct investment or 1031 Exchange process and in arranging the necessary paperwork to complete the process

From the desk of:

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