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Property repair and improvement costs before a sale and 1031 exchanges - by Lynne Bagby

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It is common for many New England real estate investors to make repairs, updates, and improvements to enhance an investment property in preparation for listing with a real estate agent or broker for sale. A commonly asked question by investors in New England is, "Can I be reimbursed from the 1031 exchange for the costs associated with improving or repairing the property immediately before the sale?" The answer is "no, not without generating a tax consequence." The reason for this is that any exchange proceeds an investor receives from a 1031 exchange are considered "boot" and are generally taxable to the extent the investor has a capital gain tax consequence.

However, improvements an investor makes to improve a relinquished property can be added to the "cost basis" of the property. In the most simplistic terms, cost basis is the amount a property is worth for tax purposes. The cost basis changes over time and becomes known as the "adjusted basis." The adjusted basis can be increased by capital improvements made to the property and is reduced by depreciation deductions taken during the ownership period and other factors.

Generally, the cost of adding capital improvements having a useful life of more than one year is added to the adjusted cost basis and are referred to as a "capital expense" and must be capitalized and depreciated over multiple years. An improvement includes enhancements that add value to the property, increases its useful life or adapts the property to a new use. Capital improvements can include room additions, new bathrooms, new roofs, decks, fencing, wiring upgrades, driveways, walkways, plumbing upgrades, and kitchen upgrades. The IRS uses the categories below to define a capital expense which must be depreciated:

- **Improvements:** A taxpayer must capitalize any expense made to improve an investment property. An expense is for an improvement if it results in a betterment to the property, restores the property or adapts the property to a new or different use.
- **Betterments:** Expenses that may result in a betterment to a property include expenses for fixing a pre-existing defect or condition, enlarging or expanding the property or increasing the capacity, strength or quality of the property.
- **Restoration:** Expenses that may be for restoration include expenses for replacing a substantial structural part of a property, repairing damage to a property as a result of a casualty loss or rebuilding the property to a like-new condition.
- **Adaptation:** Expenses that may be for adaptation include expenses for altering the property to a use that is not consistent with the intended ordinary use of the property when initially purchased or held for investment.

Costs that can be deducted as current expenses are amounts paid for incidental repairs and routine maintenance which are not added to the cost basis. Repairs are usually one-off fixes that help keep the property in good working condition and habitable. A real estate investor can deduct the cost of

minor repairs from the current year's tax liability, but not from their capital gain tax liability. The IRS clarifies in the 1040 Schedule E Instructions that "repairs in most cases do not add significant value to the property or extend its life."

For more information on basis and adjusted cost basis, read IRS Publication 551, Basis of Assets. For more information about 1031 exchanges, visit www.apixchange.com.

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