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Depreciation Rules Property Acquired in Like-Kind Exchanges

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On March 1, the Internal Revenue Service (IRS) issued temporary and proposed regulations with respect to the depreciation of property acquired in a like-kind exchange or as a result of an involuntary conversion.¹ Internal Revenue Code §1031 provides that gain or loss is not recognized on the disposition of property to the extent that such property is exchanged for like-kind property. Gain is recognized to the extent cash or other "boot" is received in the exchange. The basis of the new (replacement) property is equal to the basis of the old (relinquished) property plus any additional amounts invested in the replacement property (in the form of cash payment or debt assumption). Although replacement property acquired in an exchange must be of like kind to the relinquished property, a different depreciation regime may apply to the replacement property than applied to the relinquished property, as for example, when a parcel of land (nondepreciable) is exchanged for a building (depreciable) or when the depreciation rules have changed since the relinquished property was placed in service.

The Service had previously issued Notice 2000-4, succinctly providing that the basis of the replacement property (up to the amount of the relinquished property basis) is depreciated over the remaining recovery period of

the relinquished property. The new regulations fill in the picture outlined in the Notice, covering a variety of permutations and providing detailed rules. As is often the case, the price of guidance is complexity. One thing is clear, however, the recovery period, the depreciation method, and the applicable conventions determined under the new regulations are the only permissible methods of accounting for property within the scope of the new regulations, unless the taxpayer elects not to be governed by these regulations as discussed below.

Modified Accelerated Cost Recovery

The new regulations apply in the case of depreciable relinquished property that was placed in service after December 31, 1986, that is, property subject to the Modified Accelerated Cost Recovery System, known as MACRS. The regulations use the term "exchanged basis" to mean so much of the taxpayer's basis in the replacement property as does not exceed the taxpayer's basis in the relinquished property. Any replacement property basis in excess of the exchanged basis is referred to as "excess basis."

Simply put, exchanged basis is the basis carried over from the relinquished property and excess basis reflects additional investment in the replacement property. The regulations provide that the replacement property's exchanged basis is generally depreciated over the

remaining recovery period of the relinquished property, using the same depreciation method that was used for the relinquished property.

If, however, the replacement property has a longer recovery period than that of the relinquished property, the remaining recovery period of the relinquished property is recalculated as if the (longer) replacement property recovery period applied to the relinquished property at the time it was placed in service. In effect, the depreciable exchanged basis is depreciated over the remaining recovery period of the replacement property.

Example: A taxpayer exchanges depreciable commercial real estate for other depreciable commercial real estate. At the time the relinquished property was placed in service, the Code provided that commercial real estate had a useful life for depreciation purposes of 31.5 years, while at the time the replacement property was placed in service, a 39-year life applied. If at the time of the exchange, there were 2.5 years left on the depreciation schedule of the relinquished property (that is, in year 29 of the 31.5-year recovery period) and \$100 of remaining basis, the rules described above would recalculate the remaining depreciable life of the relinquished property by using a 39-year life. As a result, there would be 10 years left and the \$100 of exchanged basis would be depreciated over 10 years at

\$10 a year under the straight-line method.

Similarly, if the replacement property is subject to a slower method of depreciation than the relinquished property, the recovery of the exchanged basis is calculated using the replacement property method. For example, if the relinquished property were subject to an accelerated depreciation method and the replacement property were subject to the straight-line method, depreciation allowance with respect to the exchanged basis would be calculated using the straight-line method.

Under the regulations, excess basis in the replacement property is depreciated as newly purchased property that is placed in service by the acquiring taxpayer in the year in which the replacement property is placed in service by the acquiring taxpayer or, if later, the taxable year of the disposition of the relinquished property. The allowance is determined by using the recovery period, the depreciation method, and the convention prescribed for the replacement property.

One could read the reference to the disposition of the relinquished property occurring later than the acquisition of the replacement property as if the IRS were giving broad approval to reverse like-kind exchanges; however, the statement seems to have been intended only to address that situation in the case of involuntary conversions. The subject of reverse exchanges (i.e., where the replacement property is acquired before the relinquished property is transferred)

continues to be "reserved" in the §1031 regulations, and the tax ramifications remain in doubt, although the Service has issued a few private letter rulings and promulgated a revenue procedure dealing with exchange accommodation titleholders.

Deferred Exchanges: If a taxpayer disposes of the relinquished property prior to the acquisition of the replacement property, the regulations do not allow the taxpayer to take depreciation on the relinquished property during the period between the disposition of the relinquished property and the acquisition of the replacement property. This results because, in a deferred exchange, the taxpayer has no property to depreciate during that intervening period. Accordingly, the recovery period for the replacement property is suspended during this period. The regulations do not address the issue of whether a qualified intermediary is entitled to depreciation.

Election Out: The regulations permit a taxpayer to elect not to apply these rules. Pursuant to this election, a taxpayer may treat the exchanged basis as placed in service by the taxpayer at the time of replacement (resulting in the same treatment as the excess basis). This "election out" must be made by the due date (including extensions) of the taxpayer's federal tax return for the year of replacement and is made by typing or legibly printing at the top of Form 4562, Depreciation and Amortization, "ELECTION MADE UNDER SECTION 1.168(i)-6T(i)," or in the manner provided for on Form 4562 and

its instructions. The election, once made, may be revoked only with the consent of the Commissioner of Internal Revenue.

Land for Building or Building for Land: The regulations provide (and it comes as no surprise) that if land or other nondepreciable property is acquired in a like-kind exchange, the land or other nondepreciable property may not be depreciated (even if it is acquired in exchange for depreciable property). If depreciable property is received in exchange for land, it is depreciated as a newly purchased asset. These rules come into play in a typical real estate like-kind exchange where properties of equal value, but different land/building allocations are exchanged.

An Example

Example: A taxpayer exchanges a commercial property consisting of land with a basis of \$50 and a building with a basis of \$100 for a commercial property consisting of land with a value of \$50 and a building with a value of \$250. Allocating the \$150 aggregate basis of the relinquished property (based on the relative values of the land and building of the replacement property) results in a \$25 basis for the replacement land and a \$125 basis for the replacement building. Thus, through the exchange, \$25 of basis has shifted from land to building. Under the regulations, the basis in the replacement building that is attributable to the relinquished land (\$25) is treated as a new 39-year property

¹ Although the new regulations apply both to property acquired in a like-kind exchange and to property acquired as a result of an involuntary conversion (for example, as a result of investing the proceeds of casualty insurance or of a condemnation), as well as to tangible personal property, this article deals only with like-kind exchanges of real property under I.R.C. §1031.

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