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Like-Kind Exchanges: Final Rules Issued on Depreciation of Properties

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Earlier this year, the Internal Revenue Service issued final 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.

In 2000, the IRS 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. On March 1, 2004, the IRS issued temporary and proposed regulations. These regulations applied 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 final regulations issued earlier this year leave the March 2004 version largely undisturbed, adding some examples and clarifications. 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 a favorable (but confusing) twist, the regulations provide that for purposes of determining which depreciation period is longer, the replacement property is deemed to have the depreciation period it would have had had it been placed in service at the time the relinquished property was placed in service. Thus, a change in law that increases the depreciable life of a particular type of property will not prevent a taxpayer from using the remaining depreciable life of the relinquished property to depreciate the exchanged basis (if both relinquished and replacement properties are of the same type). However, a taxpayer going from a type of real property with a longer life to one with a shorter life, will be required to use the longer life.

Example: A taxpayer exchanges depreciable residential real estate for depreciable commercial real estate. At the time the relinquished property was placed in service, the Code provided that residential real estate had a 27.5 year useful life for depreciation purposes, while commercial real estate had a 31.5 year life. (At the time the replacement property was placed in service, a 39-year life applied to commercial real estate.) If at the time of the exchange, there were 6 years left on the depreciation schedule of the relinquished property (that is, the property was 21.5 years into its 27.5-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 31.5-year life, calculated from the date the relinquished property was acquired. 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. Again, the method is determined

as if the replacement property were placed in service at the time the relinquished property was placed in service. 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. The allowance is determined by using the recovery period, the depreciation method, and the convention prescribed for the replacement property.

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 situation of a qualified intermediary, and whether depreciation is allowable to a qualified intermediary is expressly "Reserved."

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 may come into play even in a typical real estate like-kind exchange where properties of equal value, but different land/building allocations are exchanged.

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 placed in service on the replacement date. The remaining $100 of building basis is depreciated over the remaining recovery period of the relinquished property. The $25 of replacement property basis allocable to land is of course not depreciated.

On different facts, a taxpayer might exchange property consisting of land with a basis of $25 and a building with a basis of $125 for property consisting of land with a value of $100 and a building with a value of $200. The aggregate basis of the relinquished property ($150) is allocated $50 to the land and $100 to the building. In this case, $25 of basis has shifted from building to land. The $50 basis of the land is nondepreciable. Since none of the basis of the replacement property is attributable to the relinquished nondepreciable property, the $100 basis in the replacement building is depreciated over the remaining recovery period of the relinquished building.

The final regulations, retain an important feature of the proposed regulations by permitting a taxpayer to elect not to apply these rules. This election is in part an acknowledgement of the complexity of these rules, which may dwarf their benefits where the relinquished property has little basis remaining. 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. The election, once made, may be revoked only with the consent of the Commissioner of Internal Revenue.

Effective Date: In general, these rules apply to like-kind exchanges or involuntary conversions of property for which the time of disposition and the time of replacement both occur after February 27, 2004, when the temporary and proposed regulations were first issued.

In sum, the regulations provide that in addition to the traditional benefit of nonrecognition of gain enjoyed by real estate owners with respect to like-kind exchanges and involuntary conversions, the "carried over" basis can generally be written off over the remaining life of the relinquished property, a favorable result that was not broadly anticipated before the issuance of Notice 2000-4 seven years ago. After adopting this generous rule, the bulk of the regulations are then devoted to a complicated system circumscribing this benefit.

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[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 focuses only on like-kind exchanges of real property under I.R.C. §1031.

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