Don’t forget a depreciation strategy for like-kind exchanges

Strategies for the use of tax-deferred like-kind exchanges have grown over the years from almost exclusively a real estate concern to one in which billions of dollars of business tangible personal property are traded each year. While the main battle continues to be waged over what dissimilarities in property are allowed and still qualify as “like kind,” another fight has developed over how the property received in a like-kind exchange is to be depreciated.

After tinkering with the depreciation rules in 2001 and 2004, the Treasury issued final regulations early in 2007. In its preamble to the final regs, the Treasury admitted that confusion and resulting inconsistency among taxpayers had developed. The final regs appear to do little to end those problems.

While deferral of gain is the principal goal of undertaking a Code Sec. 1031-compliant like-kind exchange, maximizing depreciation on the assets received in the exchange should not be ignored as a companion tax goal.

In a few cases, the depreciation side will make a like-kind exchange inadvisable; in other, simply recognizing what future depreciation will or will not be allowed may determine whether the economics of the transaction require transfer of boot or other property; in still others, using elections provided in the recently issued final regs can have a direct impact on the size of future depreciation deductions.

LIKE-KIND CLASSIFICATIONS

Like-kind property for purposes of Code Sec. 1031 gain non-recognition is property of the same nature, character or class, rather than the same grade or quality. While exchanges of real property qualify as like-kind eve though properties may be dissimilar, exchanges of personal property must be nearly identical. This treatment is implies in the examples in the Sec. 1031 regulations and has been supported by the courts.

Depreciable tangible personal property held for productive use in a trade or business or for investment qualifies for this treatment if it is exchanged for property either of like kind or of like class. Property is of a like class to other depreciable tangible personal property if the exchanged properties are within either the same general asset class or within the same product class. An exchange of depreciable tangible personal property that is not within a general asset class or a product class can still qualify for like-kind treatment only if the exchanged properties are of a like kind - a very narrow test.

Whether depreciable personal property is of a like class to other depreciable personal property is determined by classifying it among general asset classes and product classes as of the date of the exchange. Depreciable tangible personal property is classifies into one of 13 general asset classes, used for both ACRS and MACRS purposes. Product classes for depreciable tangible personal property are described in the six-digit classes of Sectors 31,32 and 33 of the North American Industry Classification System.

DEPRECIATION DISCONNECT

While like-kind property borrows asset and product class concepts from the depreciation rules, Code Secs. 1031 and 168 are not identical all the time. Dissimilarities, and those timing differences that appear when property is not simultaneously relinquished and received, create problems in reconciling depreciation and like-kind exchange treatment.

From the depreciation side of a like-kind exchange, a taxpayer is typically faced with having to determine the applicable recovery period, depreciation method and convention used for depreciating any property acquired in the exchange. A taxpayer also must decide whether to take the option on not using the final regs at all for any particular asset; or, if the regs are used, whether to choose certain optional depreciation tables.

The tax basis of MACRS property acquired in a Section 1031 like-kind exchange is simple enough to determine: Basis is equal to the property surrendered, less any cash received, plus any gain recognized. How that basis has been depreciated, however, has been inconsistent over the years. Notice 2000-4 finally provided a bifurcated method that previously many taxpayers had considered an either-or proposition:

- ❖ The "exchanged basis" (or the basis carried over from the relinquished property) is depreciated as though the exchange or conversion never occurred (that is, over the remaining recovery period of, and using the same depreciation method and convention as, the relinquished property – with exceptions, of course), and;
- ❖ The "excess basis" (or the additional consideration used to acquire the replacement property) is depreciated as if the property was newly acquired.

It took temporary regulations, and now final regulations, however, to explain many of the details of how to apply this approach. These regulations cover a host of different scenarios for depreciating property acquired by means of a like-kind exchange, too many for this article to cover. However, several details are worth highlighting.

LONGER RECOVERY/SLOWER ACCELERATION

The general rule that requires carryover of depreciation and convention applies when the relinquished and replacement properties have the same depreciable lives and the same depreciable methods, and when the replacement property has a shorter recovery period and/or a more accelerated depreciation method than the relinquished property.

The general "carryover" rule does not apply when the replacement property has a longer recovery period and/or a less accelerated depreciation method. In those instances, the exchanged basis is depreciated using a recovery period that is equal to the longer of the remaining recovery period of the relinquished property or the replacement property (assuming the replacement property was placed in service when the relinquished property was placed in service).

Similarly, the exchanged basis is depreciated using the less accelerated of the depreciation methods for the relinquished property or the replacement property.

It should be added that in no case does the depreciation treatment of the replacement property by prior owners have an effect on the depreciation treatment of the property in the taxpayer’s hands.

OPT-OUT ELECTION

Despite several simplifying provisions, the final regs remain complex and may be difficult to apply in certain situations. Recognizing this problem, the Internal Revenue Service will continue to allow taxpayers to elect out of the regs on an asset-by-asset basis. In that case, the sum of the exchanged basis and excess basis, in the form of any additional consideration, in the replacement MACRS property is treated as property placed in service at the time or replacement, and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed of at the time of disposition.

This election, however, is not only useful it the taxpayer does not want to be bothered tracking multiple assets; it also enables a taxpayer to use a shorter recovery period or a faster accelerated rate on the replacement property, rather than using the slower period and rates of the property being relinquished. In that respect, the final regs are “win-win” – use them when they are favorable, and opt out when they are not.

Under the election, the taxpayer treats the relinquished property as disposed of at the same time as the disposition of the relinquished property, and depreciates the acquired property as if it were newly acquired. The election must be made by the extended due date of the return for the replacement year.

Also, under the final regs, a taxpayer may choose whether or not to use the optional depreciation on the replacement property, regardless of whether the tables were used for the relinquished property. This is simple "do-the-math" exercise, but one that must be done if due diligence in selecting the better option is to be met.

GAPS IN THE REGS

The final regs sidestep several issues that are critical to modern like-kind exchanges. The most urgent one that needs an answer is a definitive determination of who gets the depreciation deduction during the period during which the relinquished property is yet to be found or transferred. The intermediary, someone else, no one? Since the economics of that tax benefit can make or break the underlying deal, many practitioners hope that the Treasury is quick in solving this part of the puzzle.

The regs are already clear, however, that if a taxpayer disposes of relinquished property prior to acquiring replacement property (i.e., a "deferred exchange"), the taxpayer may not depreciate either property during the period between the disposition of the relinquished property and the acquisition of the replacement property. The recovery period for the replacement property is suspended during this period.

The final regs also do not tackle the allocation of basis among multiple properties involved in like-kind exchanges or involuntary conversions, claiming that the issued is beyond its Code Sec. 168 scope. Only once basis property is determined or allocated under Section 1031 or 1033 do the final regs operate to determine the depreciation or such basis.

CONCLUSIONS

Securing non-recognition treatment under the like-kind exchange rules of Internal Revenue Code Section 1031 should not be the exclusive goal of a tax strategy surrounding the exchange of tangible business property. The right to the fastest write-off permitted for the remaining basis in the acquired property in the like-kind exchange is also significant to the economics of the overall deal.

While the IRS has not given definitive answers yet on exactly what those numbers will be in all situations, practitioners must do the best that they ca to position clients to get the best possible tax results under additional regulations yet to be issued.