Guidance on Depreciation of Replacement Property Acquired In Like-Kind Exchanges
(Reg. 1.168(i)-6)

The IRS issued final Regulations in March, 2007 on how to depreciate MACRS property acquired in a Code Section 1031 exchange when both the acquired and the relinquished property are subject to MACRS in the hands of the taxpayer. The final Regulations adopt the previously issued temporary Regulations with only minor changes.

**Taxpayers can elect-out of applying Reg. 1.168(i)-6** if it is felt that the rules are too burdensome to use. In this case, the taxpayer must treat the entire basis of the replacement property as being placed in service at the time of replacement. This is the way it was done before the IRS issued Notice 2000-4. According to the Regulations, **taxpayers who choose to elect-out of the provisions of Reg. 1.168(i)-6 can do so by typing at the top of Form 4562 “ELECTION MADE UNDER SECTION 1.168(i)-6T(i).”**

**The New Regulations**

What Reg. 1.168(i)-6 tells us is that the tax-basis of replacement property acquired in a 1031 exchange or a §1033 condemnation sale is comprised of two layers –

- **Old Basis** - The adjusted tax basis of the relinquished property (referred to as the “exchanged basis”),and

- **New Basis** - Additional basis obtained in the exchange (referred to as the “excess basis”).

The concept of “**Old Basis**” and “**New Basis**” and details of the application of the rules can be summarized as follows –

- Replacement property cannot be depreciated during the time-gap between the time the relinquished property is sold and the replacement property is
acquired and put into service. So, the new depreciation schedule for the replacement property will have a depreciation start-date for “old basis” that is consistent with the start date of the depreciation of the “New Basis.”

• "Old Basis" will continue to be depreciated in the same manner as the relinquished property was being depreciated if the replacement property has the same or shorter recovery life or depreciation method as the relinquished property had. The depreciation schedule will include the “Old Basis” just as if there had been no disposition of the asset.

• If the replacement property has a different recovery life or depreciation method than the relinquished property had, the depreciation of the “Old Basis” will have to be modified as described in the following examples.

1. The replacement property has a longer MACRS recovery period than the relinquished property had. The “old basis” (in this case, the adjusted tax basis) of the replacement property will be depreciated over what would have been left of the recovery period of the replacement property had the replacement property been placed in service in the same tax year that the relinquished property was placed in service. Cost and accumulated depreciation are netted for the depreciation schedule.

   Illustration – A taxpayer trades a 20-year farm property that he acquired ten-years ago for a 39-year commercial property. The commercial property has a 39-year MACRS recovery period and is treated as if it had been acquired ten-years ago. The remaining MACRS recovery period for the commercial property is 29-years (39-years minus 10-years). The taxpayer depreciates the adjusted tax basis of the commercial property over 29-years commencing with the date it is placed in service. This is not as good as being able to depreciate the commercial property over 20-years, but is still a break for the taxpayer.
2. **The replacement property has a shorter MACRS recovery period than the relinquished property had.** The "old basis" of the replacement property will be depreciated over the remaining recovery period of the relinquished property with no change. Cost and accumulated depreciation will not be netted for the depreciation schedule.

3. **The replacement property has a slower depreciation method than the relinquished property had.** The "old basis" (in this case, the adjusted tax basis) will be depreciated over the slower method of the replacement property. Cost and accumulated depreciation are netted for the depreciation schedule.

4. **The replacement property has a faster depreciation method than the relinquished property had.** The "old basis" of the replacement property will be depreciated using the slower depreciation method with no change. Cost and accumulated depreciation will not be netted.

**Transactions Involving Land**

**Land is never depreciable. Also, land is not MACRS property.** If depreciable property and land are exchanged for land (with no buildings or improvements), the entire basis of the relinquished property becomes the tax basis of the land acquired as replacement property. If land and improvements are exchanged for land and improvements, the allocation of basis to the replacement land must be reasonable. For instance, if the relinquished property is a commercial building with about 10% of its value in land, and the replacement property is farm land with a building on it worth about 10% of the purchase price of the replacement property, then the "exchanged basis" will have to be reallocated between buildings and land.

**Case Study**

Assume farm property traded for new commercial office building. The cost basis of the farm (land and depreciable improvements) was $500,000. Depreciable improvements with a cost of $120,000 are 20-year property and have been depreciated over 10 years. Accumulated depreciation to date of sale was
$60,000. The adjusted tax basis of the farm is $440,000 ($500,000 - $60,000). The sale price of the farm is $1,000,000 and the deferred gain is $560,000 ($1,000,000 minus $440,000 adjusted basis). The purchase price of the new office building is $1,500,000. The tax basis in the new office building is $940,000 (purchase price of $1,500,000 minus the deferred gain of $560,000).

It is necessary to calculate the tax basis of the replacement property (office building in this case) before the allocation of basis can be done as outlined below. The tax basis of a replacement property is the purchase price of the replacement property reduced by the gain that was deferred on the exchange of the relinquished property and is calculated on Form 8824 and exchange worksheets that are used to prepare Form 8824.

**Allocation of $940,000 basis in new office building - -**

<table>
<thead>
<tr>
<th>Total</th>
<th>Land</th>
<th>Buildings</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) $500,000</td>
<td>$380,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>(2) (60,000)</td>
<td>(60,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>(3) 440,000</td>
<td>380,000</td>
<td>60,000</td>
</tr>
<tr>
<td>(4) 500,000</td>
<td>(230,000)</td>
<td>730,000</td>
</tr>
<tr>
<td>(5) $940,000</td>
<td>$150,000</td>
<td>$790,000</td>
</tr>
</tbody>
</table>

- Old Basis (farm bldgs. using 20-year life)
- Accumulated depr. on old basis
- Adj basis of “old property” (20-year prop.)
- New Basis (39-year property)
- Total Tax basis of new office building

**Depreciation Schedule Presentation –**

<table>
<thead>
<tr>
<th>Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 60,000</td>
<td>Buildings, Old Basis (20 yr property)</td>
</tr>
<tr>
<td>730,000</td>
<td>Buildings, New Basis (39 yr property)</td>
</tr>
<tr>
<td>150,000</td>
<td>Land</td>
</tr>
<tr>
<td><strong>$ 940,000</strong></td>
<td>Total Basis, Replacement Property</td>
</tr>
</tbody>
</table>
Under the old method of depreciating 1031 Replacement Property before the new Reg.,
the “old basis” would have been depreciated by using the new $60,000 of adjusted tax
basis and depreciating it over 39 years ($1,538 annual depreciation). Under the new
method of depreciation, the “old basis” of $60,000 will be depreciated over 29 years (39
– 10) resulting in $2,069 annual depreciation.

Reg. 1.168(i)-6 provides the taxpayer with a benefit. If the taxpayer decides to elect out
of Reg. 1.168(i)-6 to simplify the calculation of depreciation the way it was done
previously, the taxpayer will have to accept a lower depreciation calculation. However, it
is also possible that the allocation between depreciable improvements and land using
the simpler former method may give a lower basis allocation to land and a higher
allocation to depreciable improvements. Accordingly, tax professionals will have to
analyze these alternatives for the most beneficial way to account for Replacement
Property in a 1031 Exchange.