

## DEPRECIATION OF MACRS PROPERTY

In January 2000 the Internal Revenue Service issued a Notice stating that Taxpayers should depreciate replacement MACRS property over the remaining recovery period of, and use the same depreciation method as the relinquished property that was transferred in a Section 1031 tax-deferred exchange.

For replacement MACRS property that was acquired prior to January 3, 2000 in a Section 1031 exchange, Taxpayers can either: depreciate the replacement property over the remaining recovery period, or treat the replacement property as newly-acquired MACRS property (i.e. start a new recovery period).

### The full text of IRS Notice 2000-4 follows:

**IRS Notice 2000-4:** This notice provides guidance about the depreciation of property subject to §168 of the Internal Revenue Code (MACRS Property) that is acquired in a like-kind exchange under Section 1031 or as a result of an involuntary conversion under Section 1031. The Internal Revenue Service and the Department of Treasury intend to issue regulations under Section 168 that will address these transactions. Taxpayers should follow this notice until these regulations are issued. Public comments to aid in the development of the regulations are requested by March 31, 2000.

**BACKGROUND:** Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income. The depreciation allowable for depreciable tangible property placed in service after 1986 generally is determined under Section 168 (MACRS).

Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment.

Section 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat of imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain is recognized.

The basis of property acquired in a transaction to which Section 1031 or Section 1033 applies generally is the same as the property surrendered in the transaction less any cash received plus any gain recognized. However, there is no guidance as to how to depreciate the basis of the acquired property under Section 168.

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**APPLICATION:** For purposes of determining the depreciation allowable for MACRS property acquired in an exchange of MACRS property for like-kind property to which Section 1031 applies, or acquired in replacement of involuntarily converted MACRS property to which Section 1033 applies, the acquired MACRS property should be treated in the same manner as the exchanged or involuntarily converted MACRS property with respect to so much of the Taxpayer's basis in the acquired MACRS property as does not exceed the Taxpayer's adjusted basis in the exchanged or involuntarily converted MACRS property. Thus, the acquired MACRS property is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, the exchanged or involuntarily converted MACRS property. Any excess of the basis in the acquired MACRS property over the adjusted basis in the exchanged or involuntarily converted MACRS property is treated as newly purchased MACRS property.

For acquired MACRS property placed in service on or after January 3, 2000, in a like-kind exchange of MACRS property under Section 1031 or as a result of an involuntary conversion of MACRS property under Section 1033, a Taxpayer must follow the principles set out in this notice.

For acquired MACRS property placed in service before January 3, 2000, in a like-kind exchange of, or as a result of any involuntary conversion of MACRS property, the Service is aware that Taxpayers are depreciating this acquired property either (i) in the manner set out in this notice consistent with §1.168-5(f) of the proposed Income Tax Regulations, published in the Federal Register on February 16, 1984 (49 Fed. Reg. 5940), under former §168 (ACRS); or (ii) as newly purchased MACRS property. The Service will allow a Taxpayer to continue to use its present method of depreciating the acquired property and will treat these methods as allowable methods of depreciation. However, a Taxpayer presently treating the acquired property as newly purchased MACRS property may change to treating the property under the principles in this notice, provided the property has been treated by the Taxpayer as acquired in a Section 1031 like-kind exchange or Section 1033 involuntary conversion and the change is made for the first or second taxable year ending after January 3, 2000.

**CHANGE IN METHOD OF ACCOUNTING:** A change from treating MACRS property acquired in a Section 1031 like-kind exchange or Section 1033 involuntary conversion as newly purchased MACRS property to treating the property under the principles of this notice is a change in method of accounting to which the provisions of §446 and §481 and the regulations thereunder apply. A Taxpayer changing its method of accounting for the acquired MACRS property must follow the automatic change in accounting method provisions of Rev. Proc. 99-49, 1999-52 I.R.B. 725, provided the Taxpayer makes the change in method of accounting for the first or second taxable year ending after January 3, 2000, and takes into account any necessary §481 (a) adjustment in accordance with the provisions of Rev. Proc. 99-49. The scope of limitations in Section 4.02 of Rev. Proc. 99-49 do not apply to the Taxpayer. However, if the Taxpayer is under examination, before an appeals office, or before a federal court, the Taxpayer must provide a copy of the Form 3115, Application for Change in Accounting Method, to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that the Taxpayer files the copy of the Form 3115 with the national office. The form 3115 must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

**REQUEST FOR COMMENTS:** The Service and the Treasury Department intend to issue regulations under §168 to address the depreciation of MACRS property acquired in a §1031 like-kind exchange or §1033 involuntary conversion. Before issuing proposed regulations, the Service and the Treasury Department invite comments from the public to aid in the development of these regulations. Comments should be submitted in writing by March 31, 2000, to: Internal Revenue Service, EXCHANGE OF MACRS PROPERTY FOR MACRS PROPERTY, CC:DOM:P&SI:6, Room 5112, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044. Alternatively, comments may be submitted electronically via: [http://www.irs.gov/prod/tax\\_regs/comments.html](http://www.irs.gov/prod/tax_regs/comments.html) (the Service Internet site).

**EFFECT ON OTHER DOCUMENTS:** Rev. Proc. 99-49 is modified and amplified to include this automatic accounting method change in the Appendix.

**DRAFTING INFORMATION:** The principal author of this notice of Alan H. Cooper of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Mr. Cooper at (202) 622-3110 (not a toll-free call). <<END RULING>>

**TEMPORARY AND PROPOSED SECTION 1031/168 REGULATIONS ISSUED EFFECTIVE MARCH 1, 2004: DEPRECIATION REGS. – ACQUISITION OF MACRS PROPERTY: REG. §1.168(I)-6T AND PROP. REG. 1.168(I)-6, EFFECTIVE FOR TRANSACTIONS OCCURRING AFTER FEBRUARY 27, 2004.**

**Background:** In January of 2000, the IRS issued Notice 2000-4 in an attempt to address the inconsistent treatment of depreciation of property received in a 1031 exchange. The Notice provided temporary guidelines for Taxpayers to use to depreciate **MACRS** (Modified Accelerated Cost Recovery System) property. Most business and investment use property placed in service after 1986 is depreciated using MACRS.

MACRS defines separate Recovery Periods for different property categories:

**3-year property:** tractor units, race horses over two years old and horses over 12 years old when placed in service

**5-year property:** automobiles, taxis, buses, trucks, computers, office machinery, property used in research & experimentation, breeding and dairy cattle

**7-year property:** office furniture and fixtures, any property that has not been designated as belonging to another class

**10-year property:** vessels, barges, tugs, other similar water transportation equipment, single purpose agricultural or horticultural structures, trees and vines bearing fruit or nuts

**15-year property:** depreciable improvements to land: shrubbery, fences, road, and bridges

**20-year property:** farm buildings that are not agricultural or horticultural structures

**27.5-year property:** residential rental property

**39-year property:** non-residential rental property, including home offices

The new Regs. are intended to clarify how to depreciate MACRS property acquired in exchange for like kind property under Section 1031. The Regs. apply only to MACRS property exchanged for MACRS property. A Taxpayer can elect out of the Regulations in which case the Taxpayer's entire basis in the replacement property is treated as being placed in service at the time the replacement property is acquired.

The Regs. allocate depreciable basis in replacement property in two ways:

1. Depreciable Exchanged Basis: the remaining basis of relinquished property that would have been carried over from the sale.
2. Depreciable Excess Basis: new basis in replacement property created by additional amounts paid to acquire replacement property.

Generally, Depreciable Exchanged Basis is written off over the remaining term of the relinquished property's recovery period and the Depreciable Excess Basis is treated as separate property with a new recovery period. However, different rules apply where the recovery period or the depreciation method of the relinquished property is different from that of the replacement property.

Different rules apply where depreciation method or recovery period for relinquished property is different from the depreciation method or recovery period for replacement property:

1. If the recovery period for replacement property is shorter than the recovery period for the relinquished property, the Depreciable Exchanged Basis is depreciated over the remaining recovery period of the relinquished property.
2. If the depreciation method for replacement property is more accelerated than the method used for the relinquished property (i.e. double declining balance v. straight line), the method applied to the Depreciable Exchanged Basis is the same method used for the relinquished property.
3. If the replacement property has a recovery period that is longer than the remaining recovery period of the relinquished property, the Depreciable Exchanged Basis is recovered over what would have been left of the replacement property recovery period if the replacement property had been placed in service during the same tax year as the relinquished property. (i.e. Assume relinquished property is 15 year property and replacement property is 27.5 year property. Relinquished Property was acquired in 2000 and sold in 2004. The Depreciable Exchanged Basis recovery period is 23.5 years.)
4. If the replacement property has a shorter recovery period and a slower recovery method than the relinquished property, the Depreciable Exchanged Basis is recovered over the remaining period of the relinquished property using the slower recovery method. (i.e. Assume relinquished property is 39 year property and replacement property is 27.5 year property. Relinquished property is depreciated using double declining balance method and replacement property is straight line. Relinquished property was acquired in 2000 and sold in 2004. The Depreciable Exchanged Basis is recovered over 35 years [the remaining period of the relinquished property] using straight line depreciation [the method attributed to replacement property]).

5. If the replacement property has a longer recovery period and a faster recovery method than the relinquished property, the Depreciable Exchanged Basis is recovered over what would have been left of the recovery period for the replacement property if the replacement property had been placed in service in the same year as the relinquished property but using the slower recovery method that applied to the relinquished property. (i.e.: Assume replacement property is 39 year property, with double declining balance method. Relinquished property is 15 year property, straight-line method. Relinquished property is purchased by Taxpayer in 2000 and sold in 2004. The Depreciable Exchanged Basis in the replacement property is depreciated over 35 years [the remaining recovery period of the replacement property if it had been placed in service in 2000] using straight line method.).

6. If the replacement property has a longer recovery period than the relinquished property and a slower depreciation method, the Depreciable Exchanged Basis is depreciated over the remaining recovery period of the replacement property if the replacement property had been placed in service in the same tax year as the relinquished property, using the slower depreciation method. (i.e. Assume replacement property is 39 year property, straight line. Relinquished property is 27.5 year property, double declining balance. Relinquished property was acquired by Taxpayer in 2000 and sold in 2004. The replacement property Depreciable Exchanged Basis is recovered over 35 years, using straight line method).

The Regs. also state the obvious: that land cannot be depreciated and a Taxpayer cannot continue to depreciate relinquished property during the exchange period. The Regs. reserve for further study the question or whether an EAT or a QI can depreciate property it is holding in a parking arrangement or a build to suit transaction.

Bonus Depreciation: The temporary Regs. under §1.168(k)-1T relating to bonus depreciation and §1.1400L(b)-1T relating to Liberty Zone property provide that the exchanged basis and the excess basis on the new MACRS property is eligible for additional first year bonus depreciation equal to 50% of the depreciable value of the property [defined as the property's acquisition cost less its residual value]. The bonus depreciation rules apply even if the Taxpayer elects out of the temporary regulations.

## **PERSONAL PROPERTY REG. 1.1031(A)-2T AND PROP. REG. 1.1031(A)-2**

On August 12, 2004, the Service issued final, temporary and proposed regulations replacing the use of product classes based on the standard Industrial Classification ("SIC") system with the North American Industry Classification System ("NAICS") for determining what properties are of like class for purposes of Section 1031.

Reg. §1.1031(a)-2(b) provides that depreciable tangible personal properties are like kind if the properties are in the same General Business Asset Class (as defined in Rev. Proc. 87-56) or the same product class. As of January 1, 1997, the Department of Commerce discontinued the SIC system and adopted NAICS. The temporary Regs. discontinue the use of the SIC System and adopt Sections 31 through 33 of NAICS (pertaining to manufacturing) for defining product classes.

The NAICS uses a 6-digit code and the preamble to the temporary Reg. states that properties within the same 4-digit SIC system will generally be of the same product class under the 6-digit NAICS. The temporary Regs. are effective for transfers of property on or after August 12, 2004.

Final Regs were issued May 18, 2005. The Regs apply to transfers of property made by taxpayers after Aug. 11, 2004, but taxpayers may apply them to transfers made after Dec. 31, '96 in tax years for which the statute of limitations is still open. (Reg. § 1.1031(a)-2(d)) In addition, for transfers of property made before May 20, 2005, taxpayers may treat properties within the same product classes under a 4-digit SIC code as properties of like class. (Reg. § 1.1031(a)-2(b)(8)) [4830-01-p].

**The full text of the Regulation follows:**

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

**[TD 9202]**

**RIN 1545-BD25**

**Additional Rules for Exchanges of Personal Property under Section 1031(a)**

**AGENCY: Internal Revenue Service (IRS), Treasury.**

**ACTION: Final regulations and removal of temporary regulations.**

**SUMMARY:** This document contains final regulations that replace the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining what properties are of a like class for purposes of section 1031 of the Internal Revenue Code (Code). The regulations affect taxpayers that engage in like-kind exchanges of depreciable tangible personal property.

**DATES: Effective Date:** These regulations are effective May 19, 2005.

**Applicability Dates:** For dates of applicability, see §1.1031(a)-2(d).

**FOR FURTHER INFORMATION CONTACT:** J. Peter Baumgarten, (202) 622-4920 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

**Background**

This document contains amendments to 26 CFR Part 1. On August 13, 2004, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking (REG-116265-04; 69 FR 50108) by cross reference to temporary regulations (TD 9151; 69 FR 50067) under section 1031(a). These amendments relate to the transition from the use of the four-digit codes under the SIC system to the six-digit NAICS for determining product classes of depreciable tangible personal property exchanged under section 1031. No written or electronic comments in response to the proposed regulations or requests to speak at a public hearing were received, and no hearing was held. The proposed regulations under section 1031 are adopted by this Treasury decision, and the temporary regulations are removed.

## Effective Date

These final regulations apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply the regulations to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired. Additionally, taxpayers may treat properties within the same product classes under a 4-digit SIC code as properties of like class for transfers of property made by taxpayers on or before May 19, 2005.

## Special Analysis

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S. C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

## Drafting Information

The principal author of these final regulations is J. Peter Baumgarten of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Par. 2. Section 1.1031(a)-2 is amended by:

1. Revising paragraphs (b)(3) through (b)(6), Example 3 and Example 4 of paragraph (b)(7), and paragraph (d).
2. Adding paragraph (b)(8).

The revisions and addition read as follows.

§1.1031(a)-2 Additional rules for exchanges of personal property.

(b)\* \* \*

(3) Product classes. Except as provided in paragraphs (b)(4) and (5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) Modifications of NAICS product classes. The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the **Federal Register** and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) Administrative procedures for revising general asset classes and product classes. The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See §601.601(d)(2) of this chapter.) For example, the Commissioner may determine not to follow (in whole or in part) a general asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) No inference outside of section 1031. The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) Examples. \* \* \*

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class 00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class. The sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) Transition rule. Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before May 19, 2005.

(d) Effective date. Except as otherwise provided in this paragraph (d), this section applies to exchanges occurring on or after April 11, 1991. Paragraphs (b)(3) through (b)(6), Example 3 and Example 4 of paragraph (b)(7), and paragraph (b)(8) of this section apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply paragraphs (b)(3) through (b)(6), and Example 3 and Example 4 of paragraph (b)(7) of this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired. **§1.1031(a)-2T [Removed]** Par. 3. Section 1.1031(a)-2T is removed.

**§1.1031(j)-1 [Amended]**

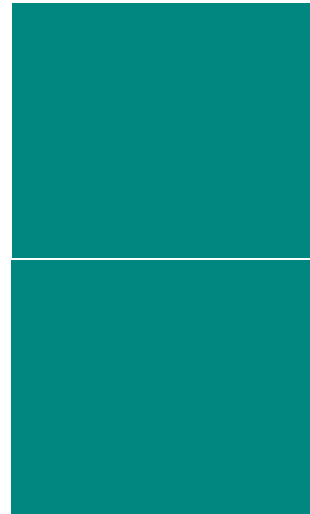
Par. 4. Section 1.1031(j)-1(d) is amended by removing the language “(SIC Code 3531)” in Example 3(ii)(C) and Example 5(i) and adding “(NAICS code 333120)” in its place.

Cono R. Namorato

Acting Deputy Commissioner for Services and Enforcement.

Approved: May 12, 2005

Eric Solomon, Acting Deputy Assistant Secretary of the Treasury.



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