Like-Kind Exchange Corner

By Mary B. Foster

An Update of the Interaction of Code Sec. 1031 Exchanges and Cost Segregation, Including Bonus Depreciation, and Other Basis Adjustments Giving Rise to Depreciation Recapture

The Journal of Passthrough Entities originally published *The Interaction of Cost Segregation, Code Sec. 1031 Exchanges and Depreciation Recapture* by Mary Foster and Martin Verdick in the January–February 2004 edition. This article discusses subsequent rulings on this issue, as well as new sources of depreciation recapture that might arise in a Code Sec. 1031 exchange of a real property asset.

Depreciation recapture in real estate dispositions will likely become more of a problem for taxpayers in the next several years. This is due in part to the continuing popularity of cost-segregation studies of real estate assets to generate more rapid depreciation deductions. In addition, in recent years, Congress has employed bonus depreciation and expanded Code Sec. 179 expensing to stimulate new construction of certain types of real estate. Further, borrowers in many of the loan workouts have reduced the tax basis in their real property in lieu of recognizing cancellation of indebtedness income ("COD") under Code Sec. 108. All of these forms of reduction in tax basis can potentially result in depreciation recapture upon the later disposition of the subject real property.

In the meantime, the volume of tax-deferred exchanges, which decreased dramatically after the real estate bubble burst, is increasing as the economy recovers. This trend should continue, especially with higher tax rates. Some of the real property exchanged in coming years will have been the subject of a cost-segregation study, or perhaps bonus depreciation, Code Sec. 179 expensing or a reduction in basis to avoid COD. To defer the gain in the exchange, the relinquished property and replacement property must

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not only be like-kind, but depreciation recapture under Code Secs. 1245 and 1250 must be avoided.

Some cost-segregation providers claim that Code Sec. 1031 is the answer to the depreciation recapture problem created by accelerated reductions in tax basis. This column examines that claim, as well as the integration of other new areas of depreciation recapture with Code Sec. 1031.

A Brief Recap of Cost Segregation

The goal of cost segregation is to increase depreciation deductions in the early years of an investment in real property.[1] Residential improvements to real property are generally depreciable over 27.5 years, and commercial improvements are generally depreciable over 39 years.[2] Real property improvements are known as "Section 1250 property" and subject to depreciation recapture under Code Sec. 1250. However, through cost segregation, many parts of real property improvements can be reclassified for depreciation purposes as personal property and land improvements. For example, wall coverings, carpeting, specialty lighting, shelving and dedicated wiring can be reclassified as five to seven-year recovery property. However, real property reclassified as personal property becomes "Section 1245 property" instead of Section 1250 property and subject to the more onerous depreciation recapture rules of Code Sec. 1245.

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Certain land improvements, such as sidewalks, driveways, fencing and landscaping, can be written off over 15 years, and the 15-year MACRS table uses the 150-percent declining balance method. In addition, bonus depreciation and expanded Code Sec. 179 expensing have added to the benefits of cost segregation in recent years, as discussed below.

Other Provisions Resulting in Basis Reductions and Possible Recapture

Bonus Depreciation

Bonus depreciation has been used by Congress in the past as a tool to stimulate purchases of tangible personal property, but it has also been used to stimulate real property construction after September 8, 2010, and currently through 2013.[3] Bonus depreciation applies to certain real property improvements (property with a depreciation recovery period of 20 years or less). The bonus amount was 100 percent of the cost of the new improvements through 2011 and then 50 percent of the cost of the new improvements in 2012 and 2013. Real property eligible for bonus depreciation also includes new "qualified leasehold improvement property." This is defined as any improvement to an interior portion of a building which is nonresidential real property if: (i) such improvement was made under or pursuant to a lease (A) by the lessee (or any sublessee) of such portion, or (B) by the lessor of such portion; (ii) such portion was to be occupied exclusively by the lessee (or any sublessee) of such portion, and (iii) such improvement was placed in service more than three years after the date the building was first placed in service. It does not include any improvement for which the expenditure was attributable to: (i) the enlargement of the building, (ii) any elevator or escalator, (iii) any structural component benefiting a common area, and (iv) the internal structural framework of the building. As a result of this provision, bonus depreciation has been used for many of the tenant improvements made in recent years, giving rise to significant potential depreciation recapture under Code Sec. 1250.

Expanded Code Sec. 179 Expensing

In 2010 and currently through 2013, up to $500,000 per year of tangible personal property, and up to $250,000 per year of "qualified real property," acquired by purchase for use in an active trade or business can be expensed under Code Sec. 179 by small businesses. "Qualified real property" includes: (1) qualified leasehold improvement property, defined above in bonus depreciation; (2) qualified retail improvements, which are defined as any improvement to an interior portion of a building that was used in the retail trade or business of selling tangible personal property to the general public (as long as such improvement was placed in service more than three years after the date the building was first placed in service and does relate to any enlargement of the building, any elevator or escalator, any structural component benefitting a common area or the internal structural framework of the building); and (3) qualified restaurant property, which is defined as a building or an improvement to a building if more than 50 percent of the building's square footage was devoted to preparation of, and seating for on-premises consumption of, prepared meals. Qualified real property placed in service during 2011 through 2013 is also depreciated over 15 years on a straight-line basis, instead of 39 years.[4] Real property expensed under Code Sec. 179 becomes "Section 1245 property" instead of Section 1250 property, and subject to the more onerous depreciation recapture rules of Code Sec. 1245.

Code Sec. 108 Basis Reductions

The tax basis of real property may be reduced under Code Sec. 108 when COD income is excluded by the taxpayer. Any reduction in basis is treated as an allowance for depreciation[5] and therefore could give rise to recapture, as discussed below, upon the disposition of the property. If the property is Section 1250 property, the taxpayer will be subject to recapture under Code Sec. 1250. If the property is neither Section 1250 property nor Section 1245 property, such as unimproved land, the taxpayer will be subject to recapture under Code Sec. 1245.[6]

Exchange Issues

A real property owner who took advantage of cost segregation, bonus depreciation, Code Sec. 179 expensing of real property or Code Sec. 108 basis adjustments may want to later exchange the property under Code Sec. 1031. However, these provisions can all result in recognition of gain in an otherwise tax-deferred exchange. For example, suppose a taxpayer disposes of a shopping center and acquires an apartment building in a like-kind exchange. The taxpayer believes that no tax is owed on the exchange because the taxpayer traded properties equal in value and took no equity out at the time of the exchange. Furthermore, both the shopping center and the apartment building are classified as real property for state law purposes, including all of the fixtures. However, the exchange may be taxable to some extent because of a failure to meet the like-kind-kind requirement, or more likely, as a result of the depreciation recapture rules of Code Sec. 1245 and Code Sec. 1250.

The Like-Kind Requirement

The relinquished property and the replacement property in an exchange under Code Sec. 1031 must be like-kind. Real property is generally like-kind to all other real property.[7] Raw land is like-kind to improved property,[8] and a shopping center is like-kind to an apartment building. Real property, however, is not like-kind to personal property,[9] and thus the distinction between real and personal property is critical for Code Sec. 1031 purposes.

Suppose the shopping center as the relinquished property in the example has significant Section 1245 property from Code Sec. 179 expensing and cost segregation. Most of the value of the shopping center, including the qualified real property under Code Sec. 179, will be real property for Code Sec. 1031 purposes and like-kind to the apartment building. However, the cost segregation study reclassified some Section 1250 property in the shopping center as Section 1245 "personal" property for depreciation purposes. For example, many of the fixtures from the shopping center have been depreciated over five years. Can these fixtures be considered real property and thus like-kind to the apartment building for Code Sec. 1031 purposes? Or must they be treated as personal property and only like-kind to other similar fixtures, a much narrower like-kind standard than for real property?

This question first requires an examination of whether depreciation classification controls for Code Sec. 1031 like-kind purposes. If the answer is no, then it requires a look at how real vs. personal property is determined under Code Sec. 1031 for fixtures.

Depreciation Classification

In CCA 201238027, the IRS states that real vs. personal property for Code Sec. 1031 purposes is determined by federal law, and that Code Sec. 48 (the ITC rules and the basis for cost segregation) and Code Sec. 1245, as well as Code Sec. 263A (capitalization of interest), are "informative" as to whether property is real or personal for federal law purposes.[10] The CCA thus gives the impression that these Code sections somehow impact the distinction between real and personal for Code Sec. 1031 purposes. However, the IRS previously ruled in CCA 200648026 that the classification of property as personal property for depreciation purposes does not determine the classification of property for purposes of the interest capitalization rules of Code Sec 263A(f).[11] This 2006 CCA is important because the analysis can easily be applied to Code Sec. 1031 to conclude that depreciation classification does not control for like-kind purposes.

The taxpayer in CCA 200648026 is a retailer who had a cost-segregation analysis of tenant improvements done for its leased stores. As a result of the study, various costs that had previously been classified as depreciable real property other than land improvements were recharacterized, for purposes of Code Sec. 168, as depreciable tangible personal property or depreciable land improvements. Nevertheless, the taxpayer capitalized interest with respect to its tenant improvements as real property under Code Sec. 263A(f).

The 2006 CCA points out that the definition of tangible personal property for Code Sec. 168 is derived from the former ITC rules, and Congress intended that tangible personal property not be defined narrowly and that local law was irrelevant in the definition.[12] The 2006 CCA notes that the legislative history of Code Sec. 263A(f) contains nothing to indicate that Congress intended the same broad construction of tangible personal property found under the ITC rules. Further, the regulations to Code Sec. 263A(f) provide that property may be real property for interest capitalization rules even though not classified as a building for purposes of the ITC rules. The 2006 CCA gives the example of a building component that is personal property under the ITC scheme because it does not relate to the operation or maintenance of a building.[13] This same item will constitute real property under Code Sec. 263A(f) if it is permanently attached and qualifies as a fixture under local law. The 2006 CCA also notes that the classification of the property for purposes of Code Sec. 263A(f) does not control its classification for purposes of cost recovery under Code Sec. 168.

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A similar analysis can be applied to Code Sec. 1031 in concluding that deprecation classification does not control for like-kind classification. Nothing in the legislative or case law history of Code Sec. 1031 indicates a broad definition of personal property for the like-kind standard. In fact, real property typically has been broadly construed under Code Sec. 1031. Unimproved real property is like-kind to improved real property, city real estate is like-kind to a farm or ranch and a lease of 30 years or more to run in real property is like-kind to a fee interest under Code Sec. 1031.[14] Water rights[15] and transferable development rights[16] can be like-kind to a fee interest, and there are several other examples of the broad classification of real property. Further, no court decisions have looked at depreciation classification when determining real vs. personal property under Code Sec. 1031.

The like-kind classification of property under Code Sec. 1031 as real or personal also should not control its classification for Code Sec. 168 purposes, and the replacement property in an exchange should be able to be both real property for the like-kind test and personal property for depreciation purposes.

Distinguishing Real and Personal Property Under Code Sec. 1031

If depreciation classification does not determine real vs. personal for Code Sec. 1031, then what factors are relevant? The regulations under Code Sec. 1031 provide that the words "like-kind" refer to the nature or character of the property and not to its grade or quality.[17] This language, by itself, is not of great use in determining whether something like a building fixture is real property for Code Sec. 1031 purposes. Further, there is a lack of other authorities on the characterization of fixtures. The case law to date on the like-kind issues for real property has involved mineral interests and other interests, such as coal supply contracts and timber cutting rights.[18] Therefore, in the absence of any other authority, taxpayers have commonly looked to the state law classification to determine if property, such as a fixture, is real or personal for Code Sec. 1031. However, CCA 201238027 casts some doubt on that method.

The exchanged properties in CCA 201238027 are identical physically, but they are located in two different U.S. states, one which classifies them as real property and the other which classifies them as personal property. The CCA concludes that properties are like-kind despite the differing state law property classifications. It states that federal law controls in determining whether properties are of the same nature and character and thus are of like-kind. State laws, while relevant, are not determinative.

The CCA addresses the exchanges of two types of fixtures. First, natural gas pipelines installed along a right of way are treated as real property despite state law characterization as personal property because they are inherently permanent structures that are affixed to real property. Further, they will ordinarily remain for an indefinite period of time, and they are transferred as part of the land to which they were affixed. Thus, they will be like-kind to any other real property, even unimproved land. It could be surmised from this part of the ruling that fixtures that are permanent for an indefinite period of time would be real property, regardless of state or depreciation characterization.

Second, the CCA discusses steam turbines, attached as fixtures in a building as components of a system for the commercial production of electricity. The steam turbines are treated as personal property despite the state classification as real property because they are "machinery and not structural components." Thus, they will not be like-kind if exchanged for other real property. The ruling comes to this conclusion with no discussion of how the IRS arrives there, other than the mention of Code Secs. 48 and 263A. Thus, a taxpayer cannot be sure about how the IRS would characterize fixtures that are in the nature of machinery, even if the machinery is permanently installed in the real property for an indefinite duration.

Where does this leave a taxpayer who is attempting to decide whether fixtures, treated as personal property for depreciation, are like-kind to real property? The case law under Code Sec. 1031 suggests that state law characterization should be followed in most situations, unless the nature and character of the property differ.[19] To date, the case law has looked at factors such as the duration of the interest. For example, mineral interests held to exhaustion are like-kind to real property, while mineral interests limited in amount or time are not like-kind to real property. Applying a similar analysis to fixtures, the taxpayer might consider whether a fixture will remain affixed for its useful life.

While state law is a convenient default rule, it is not without its problems. A particular state's law can sometimes be ambiguous on the difference between real and personal property. For example, a state may characterize permanently affixed machinery as real property for property tax valuations or realty transfer taxes, but as personal property for some purposes under the state's version of the Uniform Commercial Code.[20] States and counties may vary on how they determine if equipment is a fixture, sometimes with a bias towards classifying costly equipment as real property to generate higher real property taxes. Finally, as pointed out by the CCA, two states can characterize properties differently even though the properties are physically identical. Yet, despite these inconsistencies with state law characterization, it does give a taxpayer some framework to make a determination of real vs. personal.

Code Sec. 1245 Recapture Hurdle

If the taxpayer can successfully classify the Section 1245 property as real property for like-kind purposes, then the taxpayer still must deal with the depreciation recapture provisions of Code Sec. 1245. While the like-kind standard may be vague with "wiggle room" as to the difference between real and personal property, the depreciation recapture rules are clear in their application. They override the nonrecognition provisions of Code Sec. 1031.[21] Thus, an exchange that otherwise qualifies for nonrecognition under Code Sec. 1031 may still have depreciation recapture under the rules of Code Sec. 1245 if the value of the Section 1245 property exceeds its tax basis. This can occur if the taxpayer has a reduced basis arising from cost segregation, Code Sec. 179 expensing of qualified real property or a COD exclusion under Code Sec. 108 resulting in a basis reduction in unimproved land. This may surprise the taxpayer by triggering unexpected taxable gain in an exchange that the taxpayer thought was totally tax-deferred. In addition, if any gain is recognized, the depreciation recapture provisions cause the gain to be characterized as ordinary income and, therefore, taxed at higher ordinary income rates rather than capital gain rates.[22] So, the taxpayer is unhappy on both counts.

Under Code Sec. 1245(b)(4), assuming the value of the Section 1245 property exceeds its tax basis, the taxpayer will first have Section 1245 recapture to the extent of any taxable boot recognized in the exchange. For example, if a taxpayer takes cash out at the time of the exchange, that cash would be Section 1245 recapture. Second, the taxpayer will have Section 1245 recapture to the extent of the non-Section 1245 property like-kind property acquired in the exchange. More simply stated, the taxpayer will have Section 1245 recapture to the extent that the fair market value of the relinquished Section 1245 property exceeds the fair market value of the replacement Section 1245 property (but not in excess of the gain realized).

Using the shopping center example, if the fair market value of the Section 1245 property in the shopping center is $500,000 and the fair market value of the Section 1245 property in the apartment building is only $200,000, this represents a trade down in Section 1245 property of $300,000. Assume the realized gain of the Section 1245 property is $500,000 because the relinquished 1245 property has been fully depreciated. Therefore, the taxpayer has ordinary recapture income equal to the trade down of $300,000 (in the Section 1245 property) in the exchange, despite the fact that the exchange was totally tax-deferred under Code Sec. 1031.

Solutions to the Section 1245 Recapture Problem

Cost-segregation providers often claim the Code Sec. 1031 can solve the recapture problem created by cost segregation. It is true that a taxpayer can look for replacement property that has sufficient Section 1245 property. But this can be difficult if the taxpayer would like to exchange into a different type of real property. In the example of the exchange of a shopping center for an apartment building, a cost-segregation study of the apartment building may yield significantly less Section 1245 property than a shopping center.[23] Further, "qualified real property" under Code Sec. 179 is not applicable to the apartment building and may no longer exist at the time of the exchange.

Perhaps the most common method of avoiding recapture is to value the relinquished Section 1245 property at its remaining tax basis. Thus, in the example, the relinquished Section 1245 property would be valued at $0 to avoid the Section 1245 recapture. This might be difficult to justify if the property has appreciated greatly or if the Section 1245 property is real estate improvements, such as qualified real property. Further, the buyer, hoping to maximize depreciation deductions, will no doubt value the Section 1245 property at more than $0. Reg. §1.1245-1(a)(5) provides that:

> The total amount realized upon the disposition shall be allocated between the Section 1245 property and the non-Section 1245 property in proportion to their respective fair market values. In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the Section 1245 property and the non-Section 1245 property, any arm's length agreement between the buyer and the seller will establish the allocation. In the absence of such an agreement, the allocation shall be made by taking into account the appropriate facts and circumstances. Some of the facts and circumstances which shall be taken into account to the extent appropriate include, but are not limited to, a comparison between the Section 1245 property and all the property disposed of in such transaction of (i) the original cost and reproduction cost of construction, erection, or production, (ii) the remaining economic useful life, (iii) state of obsolescence, and (iv) anticipated expenditures to maintain, renovate, or to modernize.

In a typical real property exchange, the taxpayer will defer all the gain if the taxpayer acquires replacement real property with at least the same equity and value as the relinquished property.

Section 1250 Recapture

In the shopping center example, the taxpayer may have taken accelerated depreciation on land improvements, bonus depreciation for qualified leasehold improvements or perhaps a basis adjustment to Section 1250 property to avoid COD. All of these can create potential depreciation recapture in an exchange, although the recapture potential is narrower than that for Section 1245 property.

Under Code Sec. 1250, depreciation is generally recaptured and is taxable as ordinary income (but only up to the amount of gain realized) to the extent of the difference between the accelerated depreciation deductions taken with respect to the property and straight-line depreciation.[24] This difference is known as the "additional depreciation." Most real property is depreciated on a straight-line basis, so there would typically be no additional depreciation. The exceptions would be for land improvements, bonus depreciation of qualified leasehold improvements or Code Sec. 108 basis reductions.

Fortunately, the depreciation recapture rules for Section 1250 property in an exchange are much narrower than those for Section 1245 property. Depreciation is only recaptured as ordinary income to the extent of the *greater of:* (1) the taxable boot recognized under Code Sec. 1031, or (2) the excess of the amount of additional depreciation over the fair market value of the Section 1250 property acquired in the exchange.[25] Therefore, if no boot is received in the exchange and the value of the Section 1250 property received in the exchange equals or exceeds the amount of the additional depreciation, then no depreciation will be recaptured in the exchange. Section 1250 recapture could be a problem, however, if the taxpayer has additional depreciation and acquires nondepreciable real property, such as unimproved land, as replacement property.

Conclusion

In a typical real property exchange, the taxpayer will defer all the gain if the taxpayer acquires replacement real property with at least the same equity and value as the relinquished property. This may not be the case, however, if the relinquished real property has been the subject of cost segregation or Code Sec. 179 expensing, bonus depreciation, or Code Sec. 108 basis adjustments. These tax strategies have been used extensively in recent years as real estate went through the Great Recession. When an owner is considering an exchange of these assets, the owner must look at methods to avoid any recapture, or plan on paying the tax on the recapture. The like-kind issues presented by cost segregation are somewhat muddied by the recent IRS ruling on real vs. personal property under Code Sec. 1031, but the IRS has stated in an earlier ruling that depreciation classification should not control the classification under Code Sec. 263A(f), and this reasoning should apply to Code Sec. 1031 as well.

ENDNOTES

1. *See* the IRS Cost Segregation Audit Techniques Guide (2004) for a fuller discussion of cost segregation.
2. Code Sec. 168(c)(1).
3. Code Sec. 168(k); Act Sec. 331 of the American Taxpayer Relief Act of 2012 (P.L. 112-240).
4. Code Sec. 168(e)(3)(E).
5. Code Sec. 1017(d)(1)(B).
6. Code Sec. 1017(d)(1)(A).
7. *K.J. Crichton*, 42 BTA 490, Dec. 11,273, *aff'd*, (CA-5) 41-2 USTC ¶9638, 122 F2d 181.
8. Reg. §1.1031(a)-1(b), (c); Rev. Rul. 72-515, 1972-2 CB 466.
9. Rev. Rul. 72-151, 1972-1 CB 225; *Oregon Lumber Co.*, 20 TC 192, Dec. 19,614 (1953).
10. CCA 201238027 (Apr. 17, 2012).
11. CCA 200648026 (Aug. 25, 2006); *see also* Preamble to the Final Regulations of the Uniform Capitalization of Interest, T.D. 8584, 1995-1 CB 20, 22.
12. *See* H. Rep. No. 1447, 87th Cong., 2d Sess. (1962) 1962-3 CB 405, 415.
13. An asset that is otherwise real property as a structural component is still tangible personal property for ITC purposes if does not relate to the "operation or maintenance of the building." Thus, even though wiring is an example of a structural component under Reg. §1.48-1(e)(2), the portion of the cost of electric wiring has been allocated to tangible personal property to the extent the wiring represents the electrical load necessary for the operation of and used directly with a particular pieces of machinery within the building. The remaining portion of wiring that represents the electrical load related to the operation or maintenance of the building is a structural component and therefore real property. *See, e.g., Scott Paper Co.*, 74 TC 137, Dec. 36,290 (1980); *Hospital Corporation of America*, 109 TC 21, Dec. 52,163 (1997); *but see Boddie-Noell Enterprises, Inc.*, FedCl, 96-2 USTC ¶50,627, 36 FedCl 722 (1996).
14. Reg. §1.1031(a)-1(b) and (c)(2).
15. Rev. Rul 55-749, 1955-2 CB 295.
16. LTR 200805012, Oct. 30, 2007, LTR 200901020, Oct. 1, 2008.
17. Reg. §1.1031(a)-1(b).
18. *K.J. Crichton*, 42 BTA 490, Dec. 11,273, *aff'd*, (CA-5) 41-2 USTC ¶9638, 122 F2d 181, *Peabody Natural Resources Co.*, 126 TC 261, Dec. 56,508 (2006); *see also R. Aquilino*, SCt, 60-2 USTC ¶9538, 363 US 509, 80 SCt 1277, *Oregon Lumber Co.*, 20 TC 192, Dec. 19,614 (1953).
19. *K.J. Crichton*, 42 BTA 490, Dec. 11,273, *aff'd*, (CA-5) 41-2 USTC ¶9638, 122 F2d 181, *Peabody Natural Resources Co.*, 126 TC 261, Dec. 56,508 (2006); *see also R. Aquilino*, SCt, 60-2 USTC ¶9538, 363 US 509, 80 SCt 1277, *Oregon Lumber Co.*, 20 TC 192, Dec. 19,614 (1953).
20. U.C.C. 9-102(a)(41); U.C.C. 9-301(1)(3).
21. Code Sec. 1245(d); Reg. §1.1245-6(b).
22. Depreciation recapture must be distinguished from "unrecaptured §1250 gain" under the capital gain provisions enacted by the Tax Reform Act of 1997 (P.L. 105-34). Depreciation recapture results in ordinary income taxed at ordinary rates. Unrecaptured §1250 gain is capital gain taxed at a maximum rate of 25 percent.
23. Note that a recent case has made cost segregation of apartment buildings much less fruitful. *AmeriSouth XXXII Ltd.*, 103 TCM 1324, Dec. 58,975(M), TC Memo. 2012-67 (taxpayer could not reclassify elements of apartment building as personal property. Typical apartment building is benchmark to determine special purpose and not a generic shell building).
24. Code Sec. 1250(b).
25. Code Sec. 1250(d)(4).