

The Interaction of Cost Segregation, Code Sec. 1031 Exchanges and Depreciation Recapture

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Mary Foster and Martin Verdick explain the benefits of cost segregation and suggest answers to questions regarding how to treat a property that has been “cost segregated” when the property is disposed of and the taxpayer wants to defer gain on the disposition by acquiring replacement property, how to determine whether the properties are like-kind and the implications of the depreciation recapture rules.

Tax-deferred exchanges of real property under Code Sec. 1031 are more popular than ever. Cost segregation studies of real property to generate more rapid depreciation have also grown in use in recent years due to favorable case law, IRS rulings and the new bonus depreciation laws. The two tax planning techniques are increasingly intersecting, resulting in many questions about how to treat a property that has been “cost segregated” when the property is disposed of and the taxpayer wants to take advantage of Code Sec. 1031 and defer the gain on the disposition by acquiring replacement property. The taxpayer must determine not only if the relinquished property and replacement property are like-kind, but must also navigate around the depreciation recap-

ture rules of Code Secs. 1245 and 1250, which can result in ordinary income recapture in an exchange. This article examines these questions.

The Benefits of Cost Segregation

Improvements to real property are generally depreciable over 27.5 years if they are residential property and 39 years if they are commercial property.¹ They are known as “Code Sec. 1250

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property” and are subject to the depreciation recapture rules of that section. However, many building improvements can be reclassified as personal property and land improvements for depreciation purposes rather than structural components of a building. Examples of five-to-seven-year recovery period property include wall coverings, supplemental air conditioning and dedicated wiring. This property is known as “Code Sec. 1245 property” and subject to the depreciation recapture rules of that section. In addition to the advantage provided by shorter depreciable lives, an accelerated method of depreciation is used for personal property and land improvements. The five-, seven- and 10-year modified accelerated cost recovery system (MACRS) tables issued by the IRS use the double declining balance method of depreciation. Further, Code Sec. 179 allows for a current deduction of up to \$100,000 of the cost of personal property, and the “bonus” depreciation laws of 2002 and 2003 allow for a first-year depreciation deduction of up to 50 percent of the original cost of qualifying personal property.² 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.

The immediate tax benefits can be great if the real property improvements can be reclassified as something other than 27.5- or 39-year recovery period property. The total depreciation deductions will be the same with or without a cost segregation study over the entire depreciable life of a building and its components. The value comes in the form of an increased present value of the deductions because of

the acceleration of the depreciation deductions.

Recent Authorization of Cost Segregation

In the 1997 case of *Hospital Corp. of America*,³ the Tax Court examined the issue of whether the definition of tangible personal property for purposes of Code Sec. 168 included many items attached to a building. The IRS contended that everything was a structural component of real property and therefore Code Sec. 1250 property, and that Code Sec. 168 prohibited component depreciation. Nevertheless, the court held that the broad definition of personal property developed under prior law for purposes of the investment tax credit (ITC) was applicable to Code Sec. 168. This opened the door for cost segregation. Then, in 1999, the IRS acquiesced to this aspect of the Tax Court ruling, and the cost segregation business took off.⁴

Cost Segregation Studies

Cost segregation studies are usually performed by accounting and engineering consultants. They can be performed on new or existing buildings. Project costs are typically grouped by the engineers into major categories (e.g., concrete, structural steel, carpentry, electrical, etc.) as defined by industry standards. These categories are then placed into depreciation class lives by the accountants for tax purposes under current depreciation guidelines. A taxpayer could do its own cost segregation

analysis, but it might be subject to more scrutiny by the IRS without the third-party back up. The IRS has ruled favorably on the use of third-party cost analysis to allocate actual total costs to a building’s structural components and to the other tangible property for purposes of determining the depreciable basis.⁵ The cost segregation study may be costly depending on the complexity of the project and the tax benefits must be weighed against the resulting cost.

Table 1, provided by an accounting firm,⁶ lists various types of buildings along with an estimation of the amount of property that may be reclassified from 39-year real property to faster depreciable Code Sec. 1245 property or Code Sec. 1250 property through a cost segregation analysis.

Table 1

Type of Structure	Potential Reclassification
Retail	10–40%
Grocery Stores	15–40%
Office Buildings	10–15%
Hotels	20–40%
Warehouses	8–12%
Heavy Manufacturing	25–70%
Restaurants	15–40%

An Example

Assume that the taxpayer acquired a new manufacturing facility in December 2003 for the purchase price of \$3 million. In order to accelerate the cost recovery deductions, the taxpayer’s accounting firm did a cost segregation study on the taxpayer’s new property. The cost segrega-

tion study generated the items of property that could be depreciated or deducted faster than 39 years (see Table 2). The total value of reclassified 39-year property is \$1.2 million, consisting of \$1 million of Code Sec. 1245 property and \$200,000 of 15-year Code Sec. 1250 property.

The goal in cost segregation is to convert 27.5-year or 39-year Code Sec. 1250 property into property with shorter recovery periods and, therefore, greater initial cost recovery deductions. However, most of this property will also be classified as Code Sec. 1245 property, which has special, onerous recapture rules in an exchange under Code Sec. 1031. Furthermore, the land improvements also will have a shorter depreciation life with accelerated depreciation and thus might be subject to depreciation recapture under Code Sec. 1250. The depreciation recapture rules will be examined later, after a brief discussion of what constitutes Code Sec. 1245 property.

What's Code Sec. 1245 Property?

Code Sec. 1245(a)(3) provides that Code Sec. 1245 property includes any property that is of a character subject to the allowance for depreciation and is either personal property or certain other property described within Code Sec. 1245(a)(3)(B) through (F).

(A) **Personal property.** Reg. §1.1245-3(b) provides that "personal property" includes tangible personal property as defined in Reg. §1.48-1(c). That regulation contained rules defining property eligible for the ITC. The definition of tangible personal property was broadly construed under

Table 2

Property	Cost	Recovery Period	Recapture Type
Land improvements (sidewalks, driveway, shrubbery)	\$200,000	15	Code Sec. 1250 property
Fixtures	\$400,000	7	Code Sec. 1245 property
Machinery	\$600,000	5	Code Sec. 1245 property
Building	\$1,600,000	39	Code Sec. 1250 property
Land	\$200,000	N/A	

the ITC rules and, because this definition is now applied to Code Sec. 168, it can often result in the recharacterization of Code Sec. 1250 real property into Code Sec. 1245 personal property. The ITC regulations provide the following in defining personal property and real property under Code Sec. 1245:

The fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the [Code Sec. 1245] even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). ... Tangible personal property includes all property (other than structural components) that is contained in or attached to a building.⁷

(B) The second type of Code Sec. 1245 property is other

tangible property (not including a building or its structural components) that was (1) used as an integral part of manufacturing, production or extraction of or furnishing transportation, communications, electrical energy, gas, water or sewage disposal services; (2) constituted a research facility used in connection with any of the activities referred to in clause (1); or (3) constituted a facility used in connection with any of the activities referred to in clause (1) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).⁸

(C) The third type of Code Sec. 1245 property is so much of any real property that has an adjusted basis in which there are reflected adjustments for amortization under Code Sec. 169 (pollution control facilities), Code Sec. 179 (election to expense certain depreciable business assets), Code Sec. 179A (clean-fuel vehicle refueling property), Code Sec. 190 (qualified architectural and transportation barrier removal expenses) or Code Sec. 194 (reforestation expenditures).⁹

Other types of Code Sec. 1245 property found under Code Sec. 1245(a)(3) are:

- (D) a single purpose agricultural or horticultural structure;
- (E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum; or
- (F) any railroad grading or tunnel bore.¹⁰

A farm may contain significant Code Sec. 1245 property due to single purpose agricultural or horticultural structures,¹¹ and a taxpayer exchanging farm property for nonfarm property may encounter significant depreciation recapture problems.

What's Not Code Sec. 1245 Property?

Generally, Code Sec. 1245 property is not a building and structural components, except for those real property exceptions listed above in (B) through (F). A building and its structural components are Code Sec. 1250 property. Under the regulations, the term "building" generally means:

Any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease.¹²

The term "structural components" includes:

... such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building.¹³

It is important to note that some Code Sec. 1250 property has a cost recovery period shorter than 27.5 or 39 years and is depreciated on an accelerated basis. Examples are some land improvements, gas stations and convenience stores.¹⁴ This accelerated depreciation may result in depreciation recapture in an exchange, as discussed later.

The Exchange of the Cost Segregated Property

Cost segregation can result in recognition of gain in an other-
Table 3

	Relinquished Property	Replacement Property
FMV	\$4,000,000	\$4,000,000
Code Sec. 1245 property	\$ 900,000	\$ 500,000
Code Sec. 1250 property	\$2,900,000	\$3,300,000
Land	\$ 200,000	\$ 200,000

wise tax-deferred exchange under Code Sec. 1031. In the example above, suppose the taxpayer disposes of the manufacturing facility in 2005 and wants to acquire an office building in a like-kind exchange. The taxpayer sells the relinquished property for \$4 million. The adjusted basis of the Code Sec. 1245 property is \$700,000. The taxpayer has taken \$300,000 of cost recovery, Code Sec. 179 and bonus depreciation deductions with respect to the Code Sec. 1245 property since acquiring the manufacturing facility, and thus the "recomputed basis" is \$1 million. The Code Sec. 1245 property is valued at \$900,000 at the time of sale in 2005. The taxpayer has also taken \$30,000 of accelerated depreciation on the Code Sec. 1250 land improvements. The replacement property purchase price is \$4 million.

The taxpayer's accounting firm does a cost segregation study on the replacement property and finds \$500,000 of Code Sec. 1245 property (see Table 3). So, the taxpayer is exchanging relinquished property valued at \$4 million, consisting of \$900,000 of Code Sec. 1245 property and \$3.1 million of non-Code Sec. 1245 property, for replacement property valued at \$4 million consisting of \$500,000 of Code Sec. 1245 property and \$3.5 million of non-Code Sec. 1245 property.

The taxpayer believes that it owes no tax on the exchange because the relinquished property and replacement property

are both real property for state law purposes, and the taxpayer traded properties equal in value and took no equity out at the time of the exchange. However, both the like-kind standard and the depreciation recapture rules of Code Sec. 1245 and Code Sec. 1250 must be hurdled to obtain tax-deferred treatment.

The Like-Kind Hurdle

Code Sec. 1031 requires that the relinquished property and the replacement property in the exchange be like-kind. Real property is generally like-kind to all other real property.¹⁵ Thus, raw land is like-kind to improved property.¹⁶ Real property, however, is not like-kind to personal property.¹⁷ State law generally determines whether property is real or personal,¹⁸ although some exceptions to this general rule can be found in the regulations and case law.¹⁹ The regulations provide that the words “like-kind” refer to the nature or character of the property and not to its grade or quality,²⁰ but this analysis is not of much use in determining whether different properties will be considered like-kind.

Can Code Sec. 1245 property be like-kind to real property under Code Sec. 1031? The Code Sec. 1245 property listed in Code Sec. 1245(a)(3)(B) through (F) clearly would be real property for the purposes of Code Sec. 1031 and like-kind to other real property. For example, a single purpose agricultural structure, such as a dairy barn, would be like-kind to an office building as both are real property. Other Code Sec. 1245 property, such as improvements made to remove barriers under Code Sec. 190 to real property,

would also be like-kind to other real property.

What about the “personal property” portion of the Code Sec. 1245 property, such as fixtures or built-in appliances? The like-kind standard of Code Sec. 1031 generally looks to state law, not depreciation classification, to determine if the property is real or personal. Property, such as fixtures, can thus be personal property for depreciation and Code Sec. 1245 purposes, but real property for state law and, therefore, Code Sec. 1031 purposes. The regulations defining personal property for Code Sec. 1245, quoted above, do state “the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of [Code Sec. 1245] even though under local law the property is considered to be a fixture and therefore real property.”²¹ The definition of tangible personal property for Code Sec. 1245 purposes is derived from the former ITC rules. Congress intended that the benefit of the ITC apply expansively under former Code Sec. 48.²² Consistent with this intent, tangible personal property was not to be defined narrowly and was not to follow state law. However, nothing in the legislative history of Code Sec. 1031 suggests that Congress intended such a broad definition of personal property for the like-kind standard, and the case law under Code Sec. 1031 suggests that state law characterization should generally be followed.²³

While the state law characterization is generally followed under Code Sec. 1031, state law sometimes can 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.²⁴ And 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.

A court may not feel bound by the state law characterization as real property if the court believes that the property is more in the nature of personal property for Code Sec. 1031 purposes. Courts have found property to be personal property for Code Sec. 1031 purposes despite state law characterization as real property. These decisions involve standing timber, water rights and mineral rights.²⁵ There is no case law under Code Sec. 1031 addressing the issue with respect to real property items recharacterized as personal property for cost segregation purposes.

If the relinquished property is personal property for Code Sec. 1031 purposes, then the taxpayer must meet the stricter like-kind standard for personal property exchanges. The personal property must meet the “like class” safe harbor in the regulations,²⁶ or be similar or related in use to be considered like-kind. If the relinquished personal property is not like-kind to any portion of the replacement property, then all the realized gain on that relinquished personal property will be recognized in the exchange, and the portion of that recognized gain attributable to depreciation recapture will be ordinary income.

Code Sec. 1245 Recapture Hurdle

If the taxpayer can successfully categorize the Code Sec. 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 sometimes may be vague 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. 1031.²⁷ Thus, an exchange that otherwise qualifies for nonrecognition under Code Sec. 1031 still may have depreciation recapture under the rules of Code Sec. 1245. 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.²⁸

The recapture provisions of Code Sec. 1245 only apply to Code Sec. 1245 property. In our example, the taxpayer characterized \$1 million of the relinquished property as Code Sec. 1245 property to obtain the Code Sec. 179 deduction, bonus depreciation and shorter recovery periods. The taxpayer took cost recovery deductions of \$300,000 during the period prior to the disposition of the relinquished property and then disposed of the Code Sec. 1245 property for \$900,000.

If the relinquished property were disposed of in a taxable sale and not an exchange, then the prior depreciation deductions would

be recaptured and recognized as ordinary income under Code Sec. 1245(a)(1), but not in excess of the realized gain.

Sale Example. Taxpayer purchased Code Sec. 1245 property with a basis for cost recovery of \$1 million. Assume that after taking cost recovery deductions of \$300,000 (the amount allowable), taxpayer realizes the amount of \$900,000 upon sale of the property on January 1, 2005. Taxpayer's gain is \$200,000 (\$900,000 amount realized minus \$700,000 adjusted basis). Because the amount realized upon disposition of the property (\$900,000) is lower than its recomputed basis (\$1 million, *i.e.*, \$700,000 adjusted basis plus \$300,000 in cost recovery deductions), the entire gain is treated as ordinary income under Code Sec. 1245(a)(1).

If taxpayer realizes \$1.2 million from the sale rather than \$900,000, then the taxpayer realizes a gain of \$500,000 (\$1.2 million amount realized minus \$700,000 adjusted basis). Because the recomputed basis of the property (\$1 million) is lower than the amount realized upon its disposition (\$1.2 million), the excess of recomputed basis over adjusted basis, or \$300,000, is treated as ordinary income under Code Sec. 1245(a)(1). The remaining \$200,000 of the gain may be treated as gain from the sale or exchange of property described in Code Sec. 1231.

Next assume that the relinquished property was instead disposed of in an exchange.

The replacement Code Sec. 1245 property is only valued at \$500,000. How will the recapture rules of Code Sec. 1245 operate in our example?

Code Sec. 1245(b)(4) limits depreciation recapture in a like-kind exchange. It provides that if gain is not recognized in whole or in part in the exchange, then the amount of gain taken into account by the transferor under Code Sec. 1245(a)(1) ("the Code Sec. 1245 recapture") shall not exceed the sum of:

1. the amount of gain recognized on such disposition (determined without regard to Code Sec. 1245), plus
2. the fair market value of property acquired which is not Code Sec. 1245 property and which is not taken into account under subdivision (i) of this subparagraph (that is, the fair market value of non-Code Sec. 1245 property acquired which is qualifying property under Code Sec. 1031).

Stating this in a different manner, under (1) above, the taxpayer will first have Code Sec. 1245 recapture to the extent of any taxable boot recognized in the exchange. In our example, that taxpayer did not take any cash out of the exchange or receive any non-like-kind property. If the taxpayer had taken \$100,000 of cash out of the exchange, then that \$100,000 would be Code Sec. 1245 recapture under (1).

Second, under (2) above, the taxpayer will have Code Sec. 1245 recapture to the extent of the non-Code Sec. 1245 property like-kind property acquired in the exchange. More simply stated, the taxpayer will have Code Sec. 1245 recapture to the extent that the fair market value of the relinquished Code Sec. 1245 property in the

exchange exceeds the fair market value of the replacement Code Sec. 1245 property (but not in excess of the gain realized).

Exchange Example. The fair market value of the relinquished Code Sec. 1245 property is \$900,000 and the fair market value of the replacement Code Sec. 1245 property is \$500,000, which represents a trade down in Code Sec. 1245 property of \$400,000. Therefore, the taxpayer has ordinary recapture income equal to the realized gain of \$200,000 (in the Code Sec. 1245 property) in the exchange, despite the fact that the exchange was totally tax-deferred under Code Sec. 1031. These rules also apply in a replacement under Code Sec. 1033.

The regulations under Code Sec. 1245 provide the following example, rewritten for this article as a Code Sec. 1031 transaction rather than as a Code Sec. 1033 transaction²⁹:

Example. Jones owns Code Sec. 1245 property with an adjusted basis of \$100,000, a recomputed basis of \$116,000 and a value of \$117,000. Jones exchanges the Code Sec. 1245 property for (1) like-kind, Code Sec. 1245 property with a value of \$105,000; (2) like-kind, non-Code Sec. 1245 property with a value of \$9,000; and (3) \$3,000 cash. The \$3,000 of cash is recognized under Code Sec. 1031 as boot. The value of the like-kind, non-Code Sec. 1245 property of \$9,000 is recognized as gain under

Code Sec. 1245(b)(4)(ii). Thus, \$12,000 of gain is recognized as ordinary income under Code Sec. 1245(b)(4) (\$3,000 plus \$9,000). If, instead of acquiring the \$9,000 of non-Code Sec. 1245 property, Jones acquired \$9,000 of like-kind, Code Sec. 1245 property, then the gain would only be \$3,000.

Note that the example from the regulations under Code Sec. 1245 only requires that the replacement property be like-kind, Code Sec. 1245 property to avoid recapture. There is no requirement that the replacement Code Sec. 1245 property have the same class life for depreciation purposes as the relinquished Code Sec. 1245 property. Thus, the taxpayer could avoid depreciation recapture on relinquished real property with a class life of seven years by acquiring replacement real property of equal value with a class life of 10 years. Note that this assumes the properties involved are real property for Code Sec. 1031 purposes.

The regulations under Code Sec. 1250 provide allocation rules for the amount realized when the taxpayer disposes of Code Sec. 1250 property and Code Sec. 1245 property in a like-kind exchange. Each type of property is treated as a separate class. Then, the amount realized from each type of relinquished property (Code Sec. 1250 property, Code Sec. 1245 property or other property) is matched with the fair market value of that type of replacement property. Any remaining balance of amount realized is allocated to the other types of replacement property in any manner chosen by the taxpayer.³⁰

Valuation of Code Sec. 1245 Property

In our example, the taxpayer disposed of and acquired both Code Sec. 1245 property and non-Code Sec. 1245 property in the exchange. The taxpayer might be tempted to undervalue the relinquished Code Sec. 1245 property or overvalue the replacement Code Sec. 1245 property to avoid the Code Sec. 1245 recapture. If the fair market value of the relinquished Code Sec. 1245 property had been \$500,000 rather than \$900,000, then the taxpayer would have no Code Sec. 1245 recapture. Reg. §1.1245-1(a)(5) anticipates this issue and 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 transac-

tion 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.

Is Cost Segregation Appropriate for the Frequent Exchangor?

Should a taxpayer engage in cost segregation and characterize property as Code Sec. 1245 property if the taxpayer plans to dispose of the property in a tax-deferred exchange at some point in the future? In our example, the taxpayer owned the relinquished property for two years before the exchange. The recharacterization of \$1 million of the relinquished property as Code Sec. 1245 property resulted in \$300,000 of ordinary depreciation and Code Sec. 179 deductions. Alternatively, only \$25,000 of ordinary depreciation deductions would have been generated, if the taxpayer had retained the classification as 39-year Code Sec. 1250 property depreciated on a straight-line basis. That is an increase of \$275,000 of deductions over two years due to the cost segregation, ignoring the benefits of the time value of the first-year deductions. However, this resulted in an additional \$200,000 of ordinary income recognized in the year of the exchange upon the disposition of the Code Sec. 1245 property. That ordinary income would have been \$300,000 if the amount realized from the relinquished Code Sec. 1245 property had been \$1 million, the amount

of the recomputed basis, rather than \$900,000.

Does this make economic sense? The taxpayer effectively “purchased” an extra \$275,000 of ordinary income deductions at the cost of possibly recapturing these deductions as ordinary income in a later exchange. Had the taxpayer stuck with the characterization of 39-year Code Sec. 1250 property, the taxpayer would have only received \$25,000 of deductions with no recapture at the time of the exchange. The enormous benefit of the accelerated cost recovery deductions would appear always to outweigh costs of the later depreciation recapture at the time of the exchange. The only downside to the cost segregation would be the cost of the study, which can cost \$10,000 or more depending on the complexity of the property. Consequently, the cost segregation study should be done on properties that have significant potential for reclassification to property with shorter recovery lives, so that the tax savings cover the cost of the cost segregation study.

Basis is adjusted by depreciation “allowed or allowable.”³¹ If a taxpayer does not do a cost segregation study, can the IRS adjust basis downward by the additional amount of depreciation that would have been allowable if the cost segregation study had been done? While this is possible and may be the theoretically correct answer, it would be a harsh result, and it does not seem in the IRS’s interest to force taxpayers into undergoing cost segregation studies to protect themselves on this issue.

Despite the benefits of the accelerated deductions, the taxpayer must bear in mind the deferred tax liability and plan for some taxable gain even if the property is exchanged under Code Sec. 1031. Many tax-

payers have short memories when it comes to their prior tax benefits and will be dismayed to discover that there is significant depreciation recapture in the exchange. The taxpayer should consider the recapture liability in choosing the replacement property and look for potential like-kind replacement properties that contain a higher level of Code Sec. 1245 property.

Code Sec. 1245 Recovery Property

Code Sec. 1245 property may include “Code Sec. 1245 recovery property,” or nonresidential real property placed in service after 1981 and before 1987, which was depreciated on an accelerated rather than a straight-line method.³² Replacement Code Sec. 1245 recovery property can no longer be acquired in an exchange because that provision was removed from the Internal Revenue Code by the Tax Reform Act of 1986.³³ Thus, when a taxpayer disposes of property that was Code Sec. 1245 recovery property in a like-kind exchange and acquires other real property that is not one of the current categories of Code Sec. 1245 property, the taxpayer could recapture all the depreciation on the Code Sec. 1245 recovery property. For example, a taxpayer might exchange a shopping center acquired in 1982 that was Code Sec. 1245 recovery property for a shopping center of equal value that is only Code Sec. 1250 property. The relinquished shopping center is fully depreciated and there is a large realized gain. The taxpayer does not consult with its accountant prior to the exchange and believes that it is a fully tax-deferred exchange because the two properties are clearly like-kind. Once the accountant

alerts the taxpayer to the recapture problem, the taxpayer is unwilling to recognize the recapture gain if there is any possible position to defer it in the exchange. Arguably, the taxpayer should recapture all the depreciation as ordinary income because the taxpayer elected and benefited from the earlier accelerated depreciation.

This does seem like a harsh result because Code Sec. 1245 recovery property no longer exists due to the change in the law. Therefore, it could also be argued that if like-kind property acquired in the exchange would otherwise meet the definition of Code Sec. 1245 recovery property under prior law, then the recapture simply should be carried forward into the replacement property and recognized when it is ultimately sold in a taxable disposition. The replacement property would be considered Code Sec. 1245 property even if it otherwise now would be Code Sec. 1250 property. Once property in the hands of a taxpayer is Code Sec. 1245 property, it can never become Code Sec. 1250 property in the hands of such taxpayer.³⁴ As another possible solution to avoid at least some of the recapture income, the taxpayer may acquire like-kind property that has significant Code Sec. 1245 property, such as a manufacturing facility, and then do a cost segregation to establish the value of the Code Sec. 1245 property. The IRS has not issued any guidance on this issue.

Code Sec. 1250 Recapture

The potential for depreciation recapture in a like-kind exchange also exists for Code Sec. 1250 property, although

the recapture potential is much narrower than that for Code Sec. 1245 property. “Code Sec. 1250 property” means any tangible or intangible real property, other than Code Sec. 1245 property, which is or has been property of a character subject to the allowance for depreciation.³⁵ It includes 27.5- and 39-year recovery property, as well as 15-year recovery property for land improvements or gas stations and convenience stores.³⁶

If Code Sec. 1250 property is disposed of in a taxable disposition, 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.³⁷ This difference is known as the “additional depreciation.” If the property has been held less than one year, all depreciation is recaptured as ordinary income, but only to the extent of gain recognized.³⁸ The Tax Reform Act of 1986 generally required straight-line depreciation for all 27.5- and 39-year real property. Therefore, the recapture provisions of Code Sec. 1250 should not be applicable to most real property placed in service after 1986. However, 15-year recovery property is depreciated on an accelerated basis, and this might give rise to depreciation recapture in an exchange. Also, if the basis of property is reduced under Code Sec. 108 due to a discharge of indebtedness, the reduction is treated as “additional depreciation” under the recapture provisions of Code Sec. 1250.³⁹ Fortunately, the depreciation recapture rules for Code Sec.

1250 property in an exchange are much narrower than those for Code Sec. 1245 property.

If Code Sec. 1250 property is exchanged under Code Sec. 1031, 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 Code Sec. 1250 property acquired in the exchange.⁴⁰ Therefore, if no boot is received in the exchange and the value of the Code Sec. 1250 property received in the exchange equals or exceeds the amount of the additional depreciation, then no depreciation will be recaptured in the exchange. Contrast these limited recapture provisions with the broader recapture provisions of Code Sec. 1245 in a like-kind exchange. To avoid depreciation recapture under Code Sec. 1245, the amount of replacement Code Sec. 1245 property must at least equal the total current value of the relinquished Code Sec. 1245 property (not just the amount of prior depreciation deductions taken).

In our example, the taxpayer took \$30,000 of accelerated depreciation on the 15-year recovery land improvements. Assuming that straight-line depreciation would have been \$20,000, the additional depreciation would be \$10,000. There will be no Code Sec. 1250 recapture so long as the taxpayer acquires at least \$10,000 of Code Sec. 1250 property as replacement property, and this includes any 27.5- or 39-year Code Sec. 1250 property. Code Sec. 1250 recapture can be a problem if the taxpayer acquires unimproved land as replacement property because land is not Code Sec. 1250 property.

Depreciation Recapture and the Multiple Property Exchange Regulations

The multiple property exchange regulations under Code Sec. 1031⁴¹ (“the multi-asset regulations”) apply only when multiple properties are exchanged. A multiple property exchange should not be confused with an exchange of a single parcel of real property, such as a building, that has components of both Code Sec. 1250 and Code Sec. 1245 property, all of which are real property for Code Sec. 1031 purposes. The multi-asset regulations do not apply in that situation. They do apply if the relinquished property and replacement property consist of real property and property that is personal property for the purposes of Code Sec. 1031, such as free-standing, nonaffixed equipment.⁴² An example would be an exchange of hotels, consisting of both real property and furniture.

Assuming that the exchange is a multiple property exchange, then the multi-asset regulations require that multiple relinquished properties and replacement properties be divided into exchange groups of properties that are like-kind for the purposes of Code Sec. 1031. Gain under Code Sec. 1031 is then recognized within each exchange group to the extent of the trade down in value and equity, or exchange group deficiency, within each exchange group, with special rules for the allocation of liabilities.⁴³

The multi-asset regulations do not go the next step and integrate the depreciation recapture rules of Code Sec. 1245 or 1250 into the exchange group gain calculations.

This creates an ambiguity in how to apply the recapture rules.

Example. Taxpayer exchanges a hotel for a hotel. There are two exchange groups of like-kind properties. The relinquished property exchange groups are (1) real property valued at \$1 million, consisting of \$800,000 of Code Sec. 1250 property and \$200,000 of Code Sec. 1245 property; and (2) furniture valued at \$50,000, which is all Code Sec. 1245 property. The taxpayer also puts \$50,000 additional cash into the exchange to trade up in replacement property. The replacement property exchange groups are (1) real property valued at \$1 million, consisting of \$850,000 of Code Sec. 1250 property and \$150,000 of Code Sec. 1245 property; and (2) furniture valued at \$100,000, which is all Code Sec. 1245 property. There are no liabilities in the exchange. No gain is recognized under the multi-asset regulations and Code Sec. 1031 because the taxpayer has traded up or equal in both the real property and the furniture exchange group.

The depreciation recapture rules of Code Sec. 1245(b)(4) must also be applied to the hotel exchange. The real property exchange group has a trade down in Code Sec. 1245 property of \$50,000. The furniture exchange group has a trade up in Code Sec. 1245 property of \$50,000. Can the trade down in Code Sec. 1245 property in the real estate exchange group be offset with the trade up in Code Sec. 1245 property in the furniture exchange group to avoid any Code Sec. 1245 recapture in the real estate exchange

group? This is an open issue that is not addressed in the multi-asset regulations.⁴⁴ However, there is nothing in Code Sec. 1245(b)(4)(ii) or the relevant regulations that would prohibit this offset. Code Sec. 1245(b)(4)(ii) allows offsets of any type of relinquished Code Sec. 1245 property for any other type of replacement Code Sec. 1245 property in an exchange. It does not require that the relinquished and replacement Code Sec. 1245 properties be like-kind or in the same exchange group for the purposes of the offset.

Basis of Replacement Property

In a typical exchange involving cost segregated real property with no separate personal property, the replacement property will consist of Code Sec. 1245 real property, Code Sec. 1250 property and land. All of the gain will be deferred, except for the possibility of some Code Sec. 1245 recapture if the value of the replacement Code Sec. 1245 property is less than the value of relinquished Code Sec. 1245 property. Code Sec. 1031(d) provides that aggregate basis for the replacement property is the fair market value of the replacement property less the gain deferred in the exchange. How is this aggregate basis then allocated among the Code Sec. 1250 property, the Code Sec. 1245 property and the land? The Code Sec. 1245 regulations appear to provide that basis is first allocated to the non-Code Sec. 1245 property to the extent of its fair market value, and the balance is allocated to the Code Sec. 1245 property.⁴⁵ However, the Code. Sec. 1250 regulations appear to require basis allocation in accordance with the relative

fair market values of the like-kind replacement property, but in computing the relative fair market values, the value of the Code Sec. 1250 property is reduced by the additional depreciation not recaptured in the exchange.⁴⁶ Thus, basis allocation is uncertain in this situation.

If there is more than one exchange group, such as real property and furniture, then the basis allocation rules of the multi-asset regulations purport to apply and require allocation of basis in accordance with relative fair market values within each exchange

group.⁴⁷ However, the multi-asset regulations do not mention either set of pre-existing regulations under Code Sec. 1245 or 1250, and, thus, basis allocation is uncertain in this situation too.

The potential depreciation recapture with respect to the Code Sec. 1245 property or Code Sec. 1250 property is carried forward into the replacement Code Sec. 1245 property or Code Sec. 1250 property.⁴⁸ If several items of Code Sec. 1245 or 1250 property are received in an exchange, their potential recapture is allocated in accordance with their adjusted bases.⁴⁹

Conclusion

Many issues arise with the interaction of like-kind exchanges and the depreciation recapture rules of Code Secs. 1245 and 1250. These issues will become increasingly important to taxpayers and their advisors as cost segregation studies become more prevalent and the properties that have been cost segregated are subsequently disposed of in like-kind exchanges.

ENDNOTES

¹ Code Sec. 168(c)(1).

² Code Sec. 168(k).

³ *Hospital Corp. of America*, 109 TC 21, Dec. 52,163 (1997).

⁴ IRS Positions Reports ¶51,231, AOD/CC-1999-008 (Aug. 30, 1999).

⁵ LTR 7941002 (June 25, 1979).

⁶ RSM McGladrey, Inc.

⁷ Reg. §1.48-1(c).

⁸ Code Sec. 1245(a)(3)(B).

⁹ Code Sec. 1245(a)(3)(C).

¹⁰ Defined in Code Sec. 168(e)(4).

¹¹ Defined in Code Sec. 168(i)(13).

¹² Reg. §1.48-1(e)(1).

¹³ Reg. §1.48-1(e)(2).

¹⁴ Code Sec. 168(e)(3)(E).

¹⁵ *K.J. Crichton*, CA-5, 41-2 USTC ¶9638, 122 F2d 181, *aff'g*, 42 BTA 490, Dec. 11,273 (1940).

¹⁶ Reg. §1.1031(a)-1(b), (c); Rev. Rul. 72-515, 1972-1 CB 114.

¹⁷ Rev. Rul. 72-151, 1972-1 CB 225; *Oregon Lumber Co.*, 20 TC 192, Dec. 19,614 (1953).

¹⁸ *R. Aquilino*, S Ct, 60-2 USTC ¶9538, 363 US 509, 80 S Ct 1277, 1285, 4 LEd2d 1365, 1371; *L.Q. Coupe*, 52 TC 394, Dec. 29,610 (1969), *acq'd in result only*, 1970-1 CB xv.

¹⁹ For example, a lease of 30 years or more in real property is real property for the purposes

of Code Sec. 1031, regardless of the state characterization, whereas timber rights are personal property for the purposes of Code Sec. 1031, even though they may be real property for state law purposes.

²⁰ Reg. §1.1031(a)-1(b).

²¹ Reg. §1.48-1(c).

²² See H. REP. NO. 1447, 87th Cong., 2d Sess. (1962), 1962-3 CB 405, 415.

²³ *Aquilino*, *supra* note 18, 4 LEd2d, at 1371; *Coupe*, *supra* note 18.

²⁴ U.C.C. 9-102(a)(41); U.C.C. 9-301(1)(3).

²⁵ *Oregon Lumber Co.*, *supra* note 17; *D.G. Smalley*, 116 TC 450, Dec. 54,367 (2001); *D. Wiechens*, DC Ariz., 2002-2 USTC ¶50,708, 228 FSupp2d 1080; *W.M. Fleming*, 24 TC 818, 823-24, Dec. 21,166 (1955), *aff'd sub nom.*, *P.G. Lake, Inc.*, S Ct, 58-1 USTC ¶9458, 356 US 260, 78 S Ct 691, *rev'g* CA-5, 57-1 USTC ¶9364, 241 F2d 78.

²⁶ Reg. §1.1031(a)-(2).

²⁷ Code Sec. 1245(d); Reg. §1.1245-6(b).

²⁸ Depreciation recapture must be distinguished from "unrecaptured §1250 gain" under the capital gain provisions enacted by the Tax Reform Act of 1997. Depreciation recapture results in ordinary income taxed at ordinary rates. Unrecaptured Code Sec. 1250 gain is capital gain taxed at a maximum rate

of 25 percent.

²⁹ Reg. §1.1245-4(d)(2), Example 2.

³⁰ Reg. §1.1250-3(d)(6).

³¹ Code Sec. 1016(a)(2).

³² Former Code Sec. 1245(a)(5).

³³ Act Sec. 203(a)(1)(A) of the Tax Reform Act of 1986 (P.L. 99-514).

³⁴ Reg. §1.1250-1(e)(4).

³⁵ Code Sec. 1250(c).

³⁶ Code Sec. 168(e)(3)(E).

³⁷ Code Sec. 1250(b).

³⁸ Code Sec. 1250(b)(1).

³⁹ Code Sec. 108(b)(2)(E); Code Sec. 1017(d)(2).

⁴⁰ Code Sec. 1250(d)(4).

⁴¹ Reg. §1.1031(j).

⁴² Reg. §1.1031(j)-1(a)(1).

⁴³ Reg. §1.1031(j)-1(c).

⁴⁴ See ABA Tax Section Report: *Comments Concerning Open Issues in Section 1031 Like-kind Exchange on Open Issues*, Question 7.

⁴⁵ Reg. §1.1245-5(a)(2).

⁴⁶ Reg. §1.1250-3(d)(2)(iii).

⁴⁷ Reg. §1.1031(j)-1(c).

⁴⁸ Reg. §1.1245-2(c)(4)(i)(iii); Reg. §1.1250-3(d)(5)(i).

⁴⁹ Reg. §1.1245-2(c)(4)(iv); Reg. §1.1250-3(d)(5)(ii).

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