Like Kind Exchange

Abstract:
Effective for 2000 tax returns IRS Notice 2000-4 sets out the procedures for claiming depreciation on property received in a like-kind exchange. No longer does the taxpayer add the unrecovered cost of the traded property to the cash paid for the newly acquired property. The traded asset continues to depreciate at its existing rate and the cash paid for the new property is depreciated in accordance with current depreciation rules. At the time the asset is sold the gain attributable to depreciation recapture is treated as ordinary income. This material steps the reader through the recapture computation.

ISSUE 7: LIKE-KIND EXCHANGE, IRS NOTICE 2000-4

Notice 2000-4 sets out the procedure for claiming depreciation on property received in a like-kind exchange or in an involuntary conversion. Prior to Notice 2000-4, most practitioners added the basis carried over from the relinquished property to any new basis in the acquired property, and the total was depreciated over the life of the acquired property.

Example 1. Cust M. Harvester paid $100,000 for combine-1 in 1995 and depreciated it using MACRS 150% declining balance rates for 7-year property. In 1998, he traded the old combine for a new, 30-foot wide platform combine-2 and paid $40,000 cash. His $89,005 basis in combine-2 is calculated as follows:

Unadjusted basis of combine-1			$100,000
Less depreciation:			
1995: $100,000 X 10.71%	$10,710		
1996: $100,000 X 19.13%	$19,130		
1997: $100,000 X 15.03%	$15,030		
1998: $100,000 X 12.25% 0.5	$ 6,125		-50,995
Subtotal		$ 49,005	
Plus boot (cash)		$ 40,000	
Basis in combine-2		$ 89,005	

Cust M. depreciates the $89,005 over 7 years beginning in 1998. Therefore, his total depreciation on combine-1 and combine-2 for the year of the trade (1998) is:

Depreciation on combine-1	
$100,000 X 12.25% X 0.5 =	$ 6,125
Depreciation on combine-2	
$89,005 X 10.71% =	$ 9,532
Total	$15,657

Notice 2000-4 requires Cust M. to continue depreciating the carried-over basis over the remaining life of the relinquished property using the depreciation rate that was used for the relinquished property. Any new basis in the acquired property is depreciated over the life of the acquired property at the rate allowed for the acquired property.

Example 2. If Cust M. Harvester (from Example 1) had bought combine-1 in 1997 and made the trade in 2000, he would continue to depreciate the basis carried over from combine-1 over the useful life of combine-1 and would depreciate the $40,000 of new basis the same as any other new purchases of equipment in 2000. The 2000 depreciation combine-2 is calculated as follows:

The Fourth year depreciation on basis from combine-1		
$100,000 X 12.25% =		$12,250
First year depreciation on new basis		
$40,000 X 10.71% =		$ 4,284
Total	$16,534	

Observation. Notice 2000-4 does not require any particular record keeping system. One way to keep a record of depreciation on the acquired property is to leave the relinquished property on the depreciation schedule with a note that it was traded for the acquired property. The new basis can be entered on a new line of the depreciation schedule with a note that there is additional basis on the line for the relinquished property. If a taxpayer makes frequent trades, there can be more than two lines that reflect the depreciation and basis in the most recently acquired property.

Effective Date

The new method of depreciating property received in a trade is mandatory for property placed in service on or after January 3, 2000. Taxpayers have the option of using the old method or the new method for property placed in service before January 3, 2000.

If property placed in service before January 3, 2000, has been reported on a tax return using the old method, the **taxpayer can elect** to use the new method of depreciation for that property. The
change is treated as a change in method of accounting, so Form 3115 must be filed. Notice 2000-4 indicates that this change has automatic consent and the procedures of Rev. Proc. 99-49 must be followed.
Revenue Procedure 99-49 requires the adjustment resulting from the change in method of accounting to be spread over the 4-year period beginning with the year of change. However, there is a ***de minimis* rule** that allows the taxpayer to elect to make the full adjustment in the year of change if the adjustment is less than $25,000, positive or negative.

Example 3. Assume that Cust M. Harvester from Example 1 (1998 trade) wants to elect the new method of depreciating combine-2 that he acquired in 1998. He made this decision after he had filed his 1999 return and before he filed his 2000 return. His adjustment resulting from the change in method of accounting is the net difference between the depreciation he claimed on combine-2 and combine-1 in 1998 and combine-2 in 1999, and the amount he would claim using the new method. It is calculated as follows:

Year	Depreciation Claimed Under Old Method	Depreciation Claimed Under New Method	Net Difference
1998	$15,657	$16,534	$877
1999	$17,027	$19,902	$2,875
Total	$32,684	$36,436	$3,752

Since the total change is less than $25,000, Cust M. can elect to make the full change on his 2000 income tax return. He also claims $18,262 of depreciation for combine-2 in 2000, calculated as follows:

Sixth-year depreciation on $100,000		
$100,000 X 12.25% =		$12,250
Third-year depreciation on $40,000		
$40,000 X 15.03% =		$ 6,012
Total	$18,262	

Practitioner Note. Taxpayers who want to change to the new method on property reported under the old method must make the change in method of accounting in the first or second tax year ending after January 3, 2000. For calendar-year taxpayers, that is 2000 or 2001.

I.R.C. §1245 DEPRECIATION RECAPTURE, LIKE-KIND EXCHANGE

Gain that is recognized from a like-kind exchange of property is subject to the same recapture rules as gain recognized from the sale of the property.

- Gain recognized from the exchange of I.R.C. §1245 property is ordinary income to the extent of depreciation claimed on the property. Gain in excess of the depreciation claimed is I.R.C. §1231 gain.

- Gain recognized from the exchange of I.R.C. §1250 property is ordinary income to the extent that depreciation claimed on the property exceeds straight-line depreciation. The remaining gain is I.R.C. §1231 gain.

- If I.R.C. §1231gain from the I.R.C. §1250 property is treated as long-term capital gain, the gain due to straight-line depreciation is subject to the 25% maximum capital gain rate. The gain in excess of depreciation claimed is subject to the 20%, 10%, or 8% maximum capital gain rate.

Example 4. Assume that Cust M. Harvester from Example 3 does elect to use the new method under Notice 2000-4 for the 1998 trade of combine-1 for combine-2. He also filed Form 3115, application for change in accounting method, following Revenue Procedure 99-49 and claimed the $3,752 depreciation adjustment in 2000. Cust M. used combine-2 in 1998, 1999, and 2000. In September 2000 he sold combine- 2 for $99,000.

When Cust M. reports the sale of combine-2, he must recapture not only depreciation claimed on combine 2, but also any depreciation recapture that was carried over from combine 1. The depreciation recapture carried over from combine 1 is the lesser of:

1. The gain carried over from combine 1, or

2. Depreciation claimed on combine 1.

Practitioner Note. It is very important to determine the fair market value of the relinquished property at the time of he trade and to file Form 8824 to document the deferred gain on the relinquished property.

Since that $10,995 deferred gain carried over is less than the $50,995 depreciation claimed on combine 1, Cust M. must add the $10,995 deferred gain to the depreciation on combine 2 when he calculates his depreciation recapture on Form 4797.

Cust M. must also determine the depreciation he has claimed on combine 2. That is not obvious from the depreciation schedule because part of the depreciation is reported as depreciation of the carry over basis from combine 1 and part of it is reported as deprecation of the boot paid for combine 2.

The following table shows the two parts and the total.

DEPRECIATION OF COMBINE 2

Carryover Basis	New Basis	Total

Unadjusted basis	$49,005	Unadjusted basis	$40,000	$89,005
Less depreciation:		Less depreciation		
1998: 12.25% X .5 =	$ 6,125	1998: 10.71% =	$ 4,284	$10,409
1999: 12.25% =	$12,250	1999: 19.13% =	$ 7,652	$19,902
2000: 12.25% X .5 =	$ 6,125	2000: 15.03 X .5	$ 3,006	$ 9,131
Total	$24,500		$14,942	$39,442
Adjusted basis	$24,505		$25,058	$49,563

As the above table shows, the $39,442 total depreciation of combine 2 is one-half the 1998, and all of the 1999 and 2000 depreciation for the basis carried over from combine 1 plus all of the 1998, 1999 and 2000 depreciation for the new basis.

Therefore, Cust. M reports $50,437 on line 22 of Form 4797, calculated as follows:

Depreciation on combine 2	$39,442
Depreciation recapture carried over from combine 1	10,995
Total	$50,437

The $10,995 increase in the amount reported on line 22 will result in an incorrect adjusted basis on line 23 unless the same $10,995 is also added to the basis reported on line 21. Therefore, the amount reported on line 21 is:

Basis in combine 2	$ 89,005
Depreciation recapture deferred from combine 1	10,995
Total	$100,000

Example 5. Assume that Cust M. could have sold combine-2 for $125,000. What are the tax consequences?

Cust M.'s sale of combine-2 for $125,000 results in $50,437 of I.R.C. §1245 recapture and $25,000 of I.R.C. §1231 gain and is reported on Part III of Form 4797.

Effect of Notice 2000-4

Notice 2000-4 changes the error practitioners are likely to make if they do not compute the deferred gain at the time of a like-kind exchange and use that deferred gain to calculate depreciation recapture at the time of the sale of the acquired property.

- Before Notice 2000-4, failure to account for deferred gain from the relinquished property would result in **under-reporting** depreciation recapture upon the sale of the acquired property

- After Notice 2000-4, failure to account for deferred gain from the relinquished property will result in **over-reporting** depreciation recapture

Before Notice 2000-4. When practitioners reported a like-kind exchange prior to Notice 2000-4, they typically added the carryover basis from the relinquished property to the boot paid for the acquired property and entered the total on the depreciation schedule as the new basis in the acquired property. The relinquished property was removed from the depreciation schedule by reporting that it was sold for its basis (so that no gain or loss was reported) or by simply deleting it. If the practitioner relies solely on the information on the depreciation schedule to report depreciation recapture upon sale of the acquired asset, depreciation recapture will be under-reported in some cases because there is no record of the depreciation recapture that was deferred from the relinquished property.

After Notice 2000-4. After Notice 2000-4, most practitioners will leave the information for the relinquished property on the depreciation schedule to compute depreciation on the carryover part of the basis of the acquired property. They will make a new entry on the depreciation schedule to compute depreciation on the boot paid for the acquired property. If the practitioner relies solely on the information on the depreciation schedule to report depreciation recapture on the sale of the acquired property, depreciation recapture will be over-reported in some cases because there is no record of the deferred gain from the relinquished property, which is the limit on depreciation recapture deferred from the relinquished property.

Practitioner Note. The deferred gain is reported on line 24 of Form 8824. Therefore, filing that form and keeping a copy in the file reduces the chances of making the above errors.

Example 6. Assume the same facts as in Example 1 above. In addition, assume that Cust. M sold combine 2 in 2000 for $125,000. Depreciation on the acquired combine 2 under the pre-Notice 2000-4 method would have been $33,408.

Pre-Notice 2000-4 method. As shown on the following Part III of Form 4797, if there is no record of the $10,995 deferred gain from combine 1, depreciation recapture on sale of combine 2 is likely to be reported incorrectly as $33,408 rather than correctly as $33,408 + $10,995 = $44,403.

Notice 2000-4 method. As shown on the following Part III of Form 4797, if there is no record of the $10,995 deferred gain from combine 1, depreciation recapture on sale of combine 2 is likely to be reported incorrectly as $75,437 rather than $50,437.

Notes for Form 4797

1. Depreciation is reported improperly on line 22 in the Property A column because it does not include the $10,995 of depreciation recapture that was deferred from combine 1. The correct amount is reported in the Property B columns.

2. To make the adjusted basis on line 23 correct, the $10,995 of depreciation that was added to the depreciation on line 22 in the Property B column must also be added to the cost basis on line 21.

Practitioner Note. The cost basis of combine 2 is reported on line 25 of Form 8824.

3. The cost basis reported on line 21 in the Property C column incorrectly includes the original cost of both combine 1 and combine 2 as shown on the depreciation schedule. The correct amount is the $89,005 cost basis of combine 2 increased by the $10,995 of deferred depreciation recapture from combine 1 as shown in the Property D column.

4. Depreciation is reported improperly on line 22 in the Property C column because it includes all of the $50,995 of depreciation on combine 1 rather than just the depreciation that was deferred from combine 1. The correct amount is the $39,442 of depreciation on combine 2 plus the $10,995 deferred depreciation from combine 1, as shown in the Property D column.

Non-Income Tax Issues

The Notice 2000-4 method could be confusing for some non-income tax issues since both the original cost basis of both the relinquished property and the acquired property are still on the depreciation schedule. For example, if the depreciation schedule is used to report the taxpayer’s assets to a bank to get a loan, the bank should be informed that the relinquished asset is no longer owned so that it does not erroneously rely on both assets for collateral. Similarly, if the depreciation schedule is used to report assets for local property tax purposes, the tax liability will be overstated if the cost of relinquished assets is included in the tax base.