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New Depreciation Regulations and Notice 2000-4

— by Neil E. Harl*

Issuance of Notice 2000-4¹ more than four years ago was greeted by surprise and consternation by many taxpayers and practitioners alike.² That Notice, for like-kind exchanges and involuntary conversions, discarded the established procedure of adding the undepreciated value of assets traded or otherwise relinquished to the cash boot paid to establish the income tax basis for the acquired property.³ Rather, the Notice specified that, to the extent the income tax basis of the acquired property exceeds the basis in the exchanged property, the newly-acquired property is to be treated as newly-purchased MACRS property.⁴ Thus, two separate depreciation deductions were needed for each item of property, one for the carryover basis with the depreciation deductions claimable over the remaining recovery period and the other for the portion of the basis attributable to the additional amount paid, which is depreciated as newly-acquired property over the recovery period for the acquired asset.⁵

Enactment of bonus depreciation in 2002, retroactive to September 11, 2001,⁶ did not clarify how bonus depreciation rules were to be applied to traded property. In September, 2003, temporary regulations were issued⁷ providing that 30 percent and 50 percent bonus depreciation⁸ could be claimed on the “unadjusted depreciable basis” of eligible property which includes the entire adjusted basis of the property given up in a like-kind exchange, such as a machinery trade, plus the boot paid on the transaction.⁹ Those regulations, however, did not make it clear how the bonus depreciation percentage was to be applied (whether as of the beginning of the year of the exchange or after a half-year depreciation had been claimed).

On March 1, 2004, temporary regulations were issued¹⁰ in an attempt to harmonize established tax law, Notice 2000-4¹¹ and the 2003 temporary regulations on claiming bonus depreciation.¹²

The new regulations

General rule. The 2004 regulations¹³ start out by reciting as the general rule, in affirming the basic thrust of Notice 2000-4, that, in general, the exchanged basis (the undepreciated basis of the item traded in) is depreciated over the remaining recovery period of, and using the depreciation method and convention of, the relinquished MACRS property.¹⁴ The general rule applies if the replacement MACRS property has the same or a shorter recovery period or the same or a more accelerated depreciation method than the relinquished MACRS property.¹⁵ This would mean that, under the general rule, a taxpayer

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must depreciate the undepreciated basis of the property traded in for property with a shorter recovery period, over the longer recovery period of the relinquished property. That would be the outcome even though the taxpayer could have depreciated the entire adjusted basis of the replacement property over a shorter recovery period had the replacement property been acquired in an outright purchase rather than a trade.

Election out. For that reason, the 2004 temporary regulations provide an election not to apply the temporary regulations and to treat the entire basis of the replacement MACRS property as MACRS property placed in service by the acquiring taxpayer at the time of the replacement.¹⁶ If the election is made, the depreciation allowances for the replacement MACRS property beginning in the year of replacement and for the relinquished property in the year of disposition are not determined under the general rule.¹⁷ Rather, the exchanged basis (and excess basis, if any) in the replacement MACRS property are treated as placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as disposed of by the taxpayer at the time of the disposition.¹⁸ Thus, a taxpayer can combine the adjusted basis of the relinquished asset with the boot on the new asset which means the two items end up being treated as a single item on the depreciation schedule.

The election is made separately, asset by asset, for each like-kind exchange or involuntary conversion by each person acquiring replacement property.¹⁹ The election is made by partnerships and S corporations.²⁰ The election must be made by the due date (including extensions) of the taxpayer's return for the year of replacement.²¹ The election is made by typing or legibly printing at the top of the Form 4562, "Election Made Under Section 1.168(i)-6T(i)" or as specified in the future on Form 4562 and instructions. Once made, the election can be revoked only with the Commissioner's consent.²²

Where the general rule does not apply. The general rule does not apply if the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished property.²³ If the recovery period for the replacement property is longer than that prescribed for the relinquished property, the taxpayer's exchanged basis in the relinquished property is depreciated (beginning in the year of replacement) over the remainder of the recovery period that would have applied to the replacement property if the replacement property had originally been placed in service when the relinquished property was placed in service by the taxpayer, but using the longer recovery period of the replacement MACRS property and the appropriate convention.²⁴ Thus, the depreciable exchanged basis is depreciated over the remaining recovery period of the replacement property.

If the recovery period for the replacement property is shorter than that of the relinquished property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the same recovery period as that of the relinquished property.²⁵ Thus, the

depreciable exchanged basis is depreciated over the remaining recovery period of the relinquished MACRS property.²⁶

Partial year depreciation

As noted,²⁷ there has been uncertainty over whether the 30 percent or 50 percent bonus depreciation was to be calculated on the beginning-of-year basis for the relinquished property or after calculating a half-year of depreciation. The 2004 regulations address that uncertainty by specifying that half-year depreciation is to be calculated on the relinquished asset's basis before bonus depreciation is figured.²⁸

Example: a new tractor was purchased on October 10, 2001, for \$100,000 with \$30,000 bonus depreciation claimed plus one-half year of regular depreciation. The tractor was traded on September 15, 2002, for a replacement tractor. For 2002, the taxpayer would claim one-half year of regular depreciation on the old tractor and then claim 30 percent bonus depreciation on the basis remaining on the old tractor after the half-year of regular depreciation was subtracted. In addition, for 2002, the taxpayer could claim bonus depreciation on the boot paid on the new tractor and regular depreciation (half year) on the new tractor.

Automobiles

The temporary regulations specify that if the replacement MACRS property consists of a passenger automobile subject to the dollar limitations,²⁹ the depreciation limitation that applies for the taxable year is based on the date the replacement MACRS automobile is placed in service by the acquiring taxpayer.³⁰ In allocating the depreciation limitation, the depreciation allowance for the exchanged basis in the replacement MACRS automobile generally is limited to the amount that would have been allowable under the dollar limitations for the relinquished MACRS automobile had the transaction not occurred.³¹ The depreciation allowance for the excess basis is generally limited to the dollar limitations that apply for that taxable year less the amount of the depreciation allowance for the exchanged basis.³²

Example: H, a calendar year taxpayer, acquired and placed in service an automobile in January, 2000, for \$30,000 to be used solely in the taxpayer's business. In December 2003, H exchanged, in a like-kind exchange, automobile X plus \$15,000 cash for new automobile Y that will also be used solely in the taxpayer's business. Automobile Y is 50 percent bonus depreciation property. Both automobiles are depreciated using the double declining balance method, the half year convention and a five year recovery period. The relinquished automobile depreciation limit for 2003 for automobile X is \$1,775. The replacement automobile limit for automobile Y is \$10,710. The exchanged basis for automobile Y is \$17,315 (\$30,000 less total depreciation allowable of \$12,685 (\$3,060 for 2000, \$4,900 for 2001, \$2,950 for 2002 and \$1,775 for 2003)). Without taking the dollar limits into account, the additional first year depreciation deduction for the remaining exchanged

basis would be \$8,658 (\$17,315 x .5). Because that amount is less than \$8935 (\$10,710 (the replacement automobile dollar limit for 2003 for automobile Y) - \$1,775 (the depreciation allowable for automobile X for 2003)) the additional first year depreciation deduction for the exchanged basis is \$8,658. No depreciation deduction is allowable in 2003 for the depreciable exchanged basis because the depreciation deductions taken for automobile X and the remaining exchanged basis exceed the exchanged automobile dollar limit. An additional first year depreciation deduction of \$278 is allowable for the excess basis of \$15,000 in automobile Y. Thus, at the end of 2003 the adjusted depreciable basis in automobile Y is \$23,379 comprised of adjusted depreciable exchanged basis of \$8,657 (\$17,315 (exchanged basis) - \$8,658 (additional first year depreciation for exchanged basis)) and of an adjusted depreciable excess basis of \$14,722 (\$15,000 (excess basis) - \$278 (additional first year depreciation for 2003)).³³

In conclusion

Without much question, simplification continues to be an elusive concept.

FOOTNOTES

¹ 2000-1 C.B. 313.

² See generally 4 Harl, *Agricultural Law* § 27.03[8][a][ii]; Harl, *Agricultural Law Manual* § 4.02[16]. See also Harl, "New Rules in Handling Trades," 11 *Agric. L. Dig.* 105 (2000).

³ Harl, *supra* note 2, § 27.03[8][a][ii].

⁴ Notice 2000-4, 2000-1 C.B. 313.

⁵ *Id.*

⁶ I.R.C. § 168(k), enacted as part of the Job Creation and Worker Assistance Act of 2002, § 101.

⁷ Temp. Treas. Reg. § 1.168(k)-1T.

⁸ I.R.C. § 168(k).

⁹ Temp. Treas. Reg. § 1.168(k)-1T(a)(2)(iii).

¹⁰ T.D. 9115, amending 26 C.F.R. part 1, Temp. Treas. Reg. §§ 1.168(b)-1T, 1.168(d)-1T, 1.168(i)-OT, 1.168(i)-1T, 1.168(i)-5T, 1.168(i)-6T, 1.168(k)-1T; Treas. Reg. §§ 1.168(d)-1, 1.168(i)-1.

¹¹ 2000-1 C.B. 313.

¹² Temp. Treas. Reg. § 1.168(k)-1T(a)(2)(iii).

¹³ See note 9 *supra*.

¹⁴ Temp. Treas. Reg. § 1.168(k)-1T(c).

¹⁵ Temp. Treas. Reg. § 1.168(k)-1T(c)(4).

¹⁶ Temp. Treas. Reg. § 1.168(i)-6T(i).

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Temp. Treas. Reg. § 1.168(i)-6T(j)(1).

²⁰ *Id.*

²¹ Temp. Treas. Reg. § 1.168(i)-6T(j)(2).

²² Temp. Treas. Reg. § 1.168(i)-6T(j)(4).

²³ Temp. Treas. Reg. § 1.168(i)-6T(c)(4).

²⁴ Temp. Treas. Reg. § 1.168(i)-6T(c)(4)(i).

²⁵ Temp. Treas. Reg. § 1.168(i)-6T(c)(4)(ii).

²⁶ *Id.*

²⁷ See note 6 *supra* and accompanying text.

²⁸ See Temp. Treas. Reg. § 1.168(k)-1T(c)(5)(i). The temporary regulations are only effective prospectively, however. Temp. Treas. Reg. § 1.168(k)-1T(k).

²⁹ I.R.C. § 280F(a).

³⁰ Temp. Treas. Reg. § 1.168(i)-6T(c)(3).

³¹ *Id.*

³² *Id.*

³³ Temp. Treas. Reg. § 1.168(i)-6T(d)(3)(iii), Example 1.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

DISCHARGE. An involuntary Chapter 7 case was filed against the debtor who was a licensed farm products dealer in New York. The debtor had not paid several farm products producers and the producers filed claims under the New York State Agriculture and Markets Law (NYSAML). Those claims were pending at the time of the debtor's bankruptcy case and the debtor did not include the New York Commissioner of Agriculture

and Markets as a creditor in the bankruptcy case. The Chapter 7 case was declared a no asset case and the debtor received a discharge. The NYSAML claims were certified and paid before the discharge and the Commissioner issued a warrant against the debtor after the discharge was granted. The court held that the NYSAML claim against the debtor was discharged because the claim arose pre-petition, the bankruptcy case was a no asset case, and the failure of the debtor to not list the NYSAML claim was not fraudulent, intentional or reckless. *In re Davie*, 302 B.R. 432 (Bankr. W.D. N.Y. 2003).

The debtor was a cotton broker who filed for Chapter 7. A cotton producer attempted to sell newly-planted cotton in the future through another broker who used the debtor as a co-