Electing Out of the IRS Depreciation Rules

by Gary Gorman

Hopefully, you understand that the IRS has now issued rules that set forth how you compute depreciation on New Property you purchase in a 1031 exchange. In general, these rules state that you carry over the basis of the Old Property, leaving intact the acquisition date, cost, and amount of depreciation you have already taken. You treat the carryover basis on the Old Property as if you still owned it—but only up to a point.

If you bought up in your exchange, you then have what I call a 1031 Buy-up Adjustment for the additional basis you added to your investment as a result of the exchange. This buy-up adjustment is depreciated, starting on the date it is purchased or placed in service, using the life and method applicable to that type of property.

At this point, you then go back and adjust the depreciation method on the Old Basis to the life and method used for the buy-up adjustment if the rate used on the buy-up adjustment would yield a lesser annual depreciation. If your rate on the Old Property already yields a lesser rate than that of the New Property, you leave it as is.

Electing out of the depreciation rules.

One of the nice things about the new IRS depreciation rules is that you don't have to follow them if you choose not to. In most cases you will choose to follow them, but if you find yourself in a situation in which your annual depreciation will be dramatically better if you don't follow the new rules, you can use the IRS process that allows you to elect out of them.

I can think of two situations in which it would make sense to elect out. The first would be a situation in which you have a large basis in your Old Property and you are purchasing a property with a much longer life (which would result in much smaller annual deductions if you follow the new rules). The second situation involves Old Personal Property in which you sold a large number of small pieces of equipment and replaced them with one or two large pieces of equipment. In this situation you've kept track of each separate piece of small equipment and would really like to end up with a depreciation schedule with only one or two pieces of equipment on it to track.

What happens if you elect out?

In simple terms, if you elect out of the IRS depreciation rules you treat the Old Property as if you sold it on the date of the exchange, and you treat the New Property as if you bought it on the date you purchased it. In other words, you treat the transaction as if you did not do an exchange—with two big differences: you do not recognize the gain on the sale of the Old Property on your tax return, and your basis in the New Property is your rollover basis plus your 1031 adjustment.

Let's go back to Fred and Sue's example and see what happens when they elect out of the new depreciation rules on their exchange.

Let's say that Fred and Sue sell an office building and, through a 1031 exchange, acquire an apartment building. Their carryover basis in the office building is $1,250,000, and their buy-up adjustment to acquire the apartment building is $250,000. The MACRS depreciable life of the office building is 39 years, and the MACRS depreciable life of the apartment building is 27.5 years.

Under the new depreciation rules, Fred and Sue's annual depreciation deduction on the apartment building would be $41,141 as seen in figure 1.

	Amount	Life	Method	Annual Depreciation
Building	$1,250,000	39 (1)	S.L.	$32,051
Buy-up Adjustment	250,000	27.5	S.L.	9,090
	$1,500,000			$41,141

Fig. 1: Example of annual depreciation deduction following IRS rules

(1) The 39-year life of the Old Property (the office building) is longer than the 27.5-year life of the New Property (the apartment building). Under the new IRS depreciation rules, we must stay with the 39-year life method because it yields a smaller annual depreciation deduction.

If Fred and Sue elect out of the depreciation rules under IRS Reg. 1.168-1T, their annual depreciation deduction will look like figure 2. Their depreciation deduction will increase by $13,404, an increase of almost 33 percent in their annual deduction. When they make the election, they treat the depreciation of

	Amount	Life	Method	Annual Depreciation
Apartment Building	$1,500,000	27.5	S.L.	$54,545

Fig. 2: Example of annual depreciation deduction for electing out

Old Property as if they had sold it. Of course, because they did an exchange they don't report the sale as a taxable transaction in their tax return; they merely quit depreciating it.

Then they treat the New Property as if they had bought it without an exchange in their tax return. Their basis in this New Property is their rollover basis from the Old Property of $1,250,000 plus their buy-up adjustment of $250,000 in the New Property, a total basis of $1,500,000. Comparing the two schedules (figures 1 and 2) you should notice two things. First, the amount of the annual depreciation went up significantly (from $41,141 to $54,545), and second, the depreciation schedule is much cleaner. So, to restate the comment I made at the beginning of this section: the two places I expect to see taxpayers electing out of the depreciation rules are situations in which the asset life cycle of the New Property is significantly shorter, and situations in which they want to streamline their depreciation schedules—even if there is no tax advantage in doing so.

If you make this election, make sure you keep very good records of what you did: you'll need them later because the regulations make no mention of what happens to the depreciation you've taken on the Old Property. Since you did not recognize any of the gain because of the exchange, you won't trigger any of the built-in depreciation recapture on the Old Property. I can't believe that the IRS won't eventually figure out that the *recapture taint* (obligation) on the Old Property disappears when you elect out. I expect that they will come along later and require you to roll the obligation over to the New Property. In the event that happens, you'll need to go back and pick up this information out of your notes.

Who makes the election?

One of the requirements of a 1031 exchange is that the taxpayer who owns the Old Property is the taxpayer who must do the exchange and purchase the New Property. If a partnership owns the Old Property, the partnership is the taxpayer who does the exchange and the exchange, is reported in the partnership's tax return—not the returns of the individual partners. Therefore, it stands to reason that the depreciation records are maintained at the partnership level and that an election out of the depreciation rules would be made by the partnership and not the partners. If the Old Property is owned by a corporation that is part of a consolidated group, each corporation must make its own election.

Property covered by the election.

The election is made on a property-by-property basis. This means that if Fred and Sue sold three properties in the same tax year and did a 1031 exchange for each of them, they would be allowed to follow the depreciation rules for some of the properties, but elect out on the others.

Also, the election out is not binding on future transactions involving that property. If Fred and Sue sell the property that they elected out of in the above example a couple of years later, they don't have to elect out again: they could decide to follow the IRS ruling at that point. Of course, they can't go back and pick up the depreciation schedule from when they first elected out: when they elected out, they permanently started a whole new depreciation schedule on that property.

Making the election.

The election is made in the tax return filed for the year in which the New Property is purchased. If the tax return is extended, the election is extended as well. This means that if Fred and Sue sell their Old Property in December 2012, and purchase the New Property in January 2013, they must make the election on their 2013 return, which will be filed in 2014. Fred and Sue could legally extend their 2013 tax return until October 15, 2014. In other words, they could buy their New Property in January of 2013, but could wait until October of 2014 to decide how they want to depreciate it.

Another thing to notice about this example is that Fred and Sue must report the exchange of their Old Property on their 2012 tax return, but they make the decision on how they want to depreciate the New Property when they file their 2013 tax return. The reason for this is even though they sold the Old Property in 2012, they won't start depreciating the New Property until 2013—the year of the purchase.

You elect out of the depreciation rules by writing the following statement at the top of Form 4562 (*Depreciation and Amortization*) that you file for the year in which you purchased the New Property:

ELECTION MADE UNDER SECTION 1.168(i)-6T(i).

Fred and Sue's election on Form 4562 will look like figure 3.

> (1) Because 2013 is the first year that the property is in service, and because we used the mid-month conversion, Fred and Sue get a half-month's depreciation for the month the property was placed into service (January) and a full month's depreciation for each month of the rest of the year. In other words, they get 11.5/12ths depreciation (or $52,273) the first year rather than a full year's depreciation of $54,545, as shown on Line 19h in figure 3.

Election made under section 1.168(i) - 6 T (i).

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172

20__

Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Fred and Sue Jones	Form 8825 Building	123-45-6789

Part I Election To Expense Certain Property Under Section 179

Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
7	Listed property. Enter the amount from line 29	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 20-- Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 20--. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II Special Depreciation Allowance and Other Depreciation (Do not include listed property.) (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III MACRS Depreciation (Do not include listed property.) (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 20__	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 20-- Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property	01/04	1,500,000	27.5 yrs.	MM	S/L	52,273 (1)
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 20-- Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV Summary (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12906N Form **4562**

Fig. 3: Example of how to cite election out of rules

Revoking the election after it's made.

The rules provide that you can revoke the election out of the depreciation rules only with the consent of the Commissioner of Internal Revenue. I wouldn't count on them making it easy for you to get out of an election, once made. If you do want out, make sure you have a good reason.