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# Recapture in Like-Kind Exchanges

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## Recapture in Like-Kind Exchanges

-by Neil E. Harl\*

The increased use of like-kind exchanges<sup>1</sup> with real estate in recent years, coupled with the long-standing heavy usage of like-kind exchanges with tangible personal property<sup>2</sup> has focused a great deal of attention on such exchanges.<sup>3</sup> One area that requires special care and handling is the potential for recapture of depreciation under I.R.C. §§ 1245 and 1250 in an otherwise tax-free, like-kind exchange.<sup>4</sup>

### Like-kind exchanges of real property

Because real property exchanges can be like-kind even if one tract is bare land, completely undeveloped, and the other tract is heavily developed with both Section 1250 property and Section 1245 property involved,<sup>5</sup> the recapture problems are more likely to arise with real property exchanges. That is because improved real estate qualifies as like-kind to unimproved real estate,<sup>6</sup> urban real estate (improved or unimproved) can be exchanged for a ranch or farm,<sup>7</sup> a conservation easement can be exchanged for a fee simple interest in different farmland,<sup>8</sup> and an exchange of water rights in perpetuity (considered real property under state law) for a fee simple interest in land is like-kind.<sup>9</sup> The fact that all of these are like-kind exchanges has lured some property owners into believing that such exchanges are completely tax-free. That overlooks, however, the possibility of recapture of depreciation in connection with what are clearly like-kind exchanges.

### Section 1245 recapture

Section 1245 property is often part of a like-kind exchange on one or both of the properties involved,<sup>10</sup> that involves depreciable personal property (such as machinery and equipment)<sup>11</sup> as well as the "other property" branch of I.R.C. § 1245 which includes tangible property (but not a building or structural components) used in conjunction with manufacturing, production (including farm and ranch production) or extraction plus various utility-type services.<sup>12</sup> The other property branch includes fences, tile lines, feeding floors and grain bins,<sup>13</sup> for example.

If Section 1245 property is disposed of in a like-kind exchange, Section 1245 recapture must be recognized to the extent of the amount of gain recognized on the exchange plus the fair market value of the property acquired that is not Section 1245 property.<sup>14</sup> Thus, in an exchange of improved for unimproved land where part or all of the improvements are Section 1245 property, the exchange is likely to lead to recapture consequences for the transferor of the improved property. The Form 8824, Like-Kind Exchanges, in line 21 reminds taxpayers of the possibility of recapture.

If property is acquired in a like-kind exchange, the income tax basis is the same as the basis of the property exchanged, decreased by money received by the taxpayer and increased by the gain (or decreased by the loss) on the exchange.<sup>15</sup>

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*Example:* a taxpayer exchanges, in a like-kind exchange, property A, which is Section 1245 property with an adjusted basis of \$100,000, for property B which has a fair market value of \$90,000 and property C which has a fair market value of \$35,000. Upon the exchange, \$25,000 of gain is recognized since property C is not Section 1245 property. The basis of the properties received in the exchange is \$125,000 (the basis of the property transferred, \$100,000, plus the amount of gain recognized, \$25,000), of which the amount allocated to property C is \$35,000 (the fair market value) and the residue of \$90,000 is allocated to property B.<sup>16</sup>

### Section 1250 property

If any real property (other than Section 1245 property) which is of a character subject to an allowance for depreciation (such as a farm shop, machinery storage or general purpose sheds or barns)<sup>17</sup> is transferred in a like-kind exchange, the amount of gain taken into account as recapture income does not exceed the greater of the gain recognized on the exchange on the disposition or the excess, if any, of the gain reported as ordinary income because of additional depreciation had the property been sold over the fair market value of the Section 1250 property acquired in the transaction.<sup>18</sup>

In the case of Section 1250 property, the recapture of depreciation is partially or fully deferred until there is a disposition of the acquired property.<sup>19</sup>

As for basis adjustment, the basis of property received is the basis of the exchanged Section 1250 property—(1) decreased by the amount of any money received that was not spent acquiring similar property, (2) increased by the amount of gain recognized and (3) decreased by the amount of loss recognized.<sup>20</sup> If more than one item of property of each type is received, the total basis is allocated to the individual items of property.<sup>21</sup>

### In conclusion

As part of the checklist of factors to consider in a like-kind exchange, it is important to consider the possibilities for I.R.C.

§ 1245 or I.R.C. § 1250 recapture. In some exchanges, the recapture amount can be significant.

### FOOTNOTES

<sup>1</sup> I.R.C. § 1031. See generally, Harl, *Agricultural Law* § 4.02[16] (2004). See also Harl, “New Limits on ‘Reverse’ Like-Kind Exchanges,” 15 *Agric. L. Dig.* 185 (2004); Harl, “New Rules on Like-Kind Exchanges with Personal Property,” 15 *Agric. L. Dig.* 129 (2004); Harl, “Is a Partition an ‘Exchange?’” 14 *Agric. L. Dig.* 41 (2003).

<sup>2</sup> See Treas. Reg. § 1.1031(a)-2(b).

<sup>3</sup> See, e.g., Harl, “Partition and the Related Party Rule,” 13 *Agric. L. Dig.* 145 (2002).

<sup>4</sup> See Treas. Reg. §§ 1.1245-4(d)(1), 1.1250(d)(4).

<sup>5</sup> See generally Treas. Reg. § 1.1031(a)-1(c).

<sup>6</sup> Treas. Reg. § 1.1031(a)-1(c).

<sup>7</sup> *Id.*

<sup>8</sup> E.g., Ltr. Rul. 9851039, September 15, 1993.

<sup>9</sup> Rev. Rul. 55-749, 1955-2 C.B. 295. See Ltr. Rul. 200404044, October 23, 2003 (exchange approved where water rights were limited in quantity to a specified amount per year rather than limited in quantity to a specific percentage of the overall supply of agricultural water). But see *Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Ariz. 2002) (court viewed restrictions as making exchange non-like kind).

<sup>10</sup> See generally Harl, *Agricultural Law* § 31.02 (2004).

<sup>11</sup> I.R.C. § 1245(a)(3)(A).

<sup>12</sup> I.R.C. § 1245(a)(3)(B).

<sup>13</sup> See I.R.C. § 1245(a)(3)(B)(iii) (bulk storage of fungible commodities).

<sup>14</sup> I.R.C. § 1245(b)(4); Treas. Reg. § 1.1245-4(d)(1), (4).

<sup>15</sup> I.R.C. § 1031(d).

<sup>16</sup> Treas. Reg. § 1.1245-5(a)(2).

<sup>17</sup> I.R.C. § 1250(c).

<sup>18</sup> I.R.C. § 1250(d)(4)(C). See Treas. Reg. § 1.1250-3(d).

<sup>19</sup> I.R.C. § 1250(d)(4)(E).

<sup>20</sup> Treas. Reg. § 1.1250-3(d)(4).

<sup>21</sup> See Treas. Reg. § 1.1250-3(d)(4).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

### BANKRUPTCY

#### GENERAL

**AUTOMATIC STAY.** The debtor filed for Chapter 7 and notice was served on the bank which held a mortgage against the debtor’s home. After the notice was given, the bank filed an unlawful detainer action but the action was dismissed three weeks later. The debtor sought damages for emotional distress from the bank’s violation of the automatic stay. The Bankruptcy Court and District Court held that damages for emotional distress could not be awarded for violation of the automatic stay. The appellate court

reversed, holding that damages for emotional distress qualified as “actual damages” provided for in Section 362(h). *In re Dawson*, 390 F.3d 1139 (9th Cir. 2004), *rev’g on reconsideration*, 367 F.3d 1174 (9th Cir. 2003).

The debtor and the debtor’s father borrowed money from a bank to purchase a pickup truck. The bank records showed that the truck was purchased for operation at a farm and the loan was to be paid from farm income. The debtor and father executed a “Commercial Security Agreement” for the bank. The truck was listed as collateral for the loan as well as any other indebtedness of the debtors to the bank. The debtor filed for Chapter 13 bankruptcy and the bank levied against the father’s bank account for payment of the loan. The debtor argued that the levy violated