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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9314

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Depreciation of MACRS Property That is Acquired in a Like-Kind Exchange or As a Result of an Involuntary Conversion

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to the depreciation of property subject to the accelerated cost recovery system under section 168 of the Internal Revenue Code (MACRS property). Specifically, these final regulations provide guidance on how to depreciate MACRS property acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033 when both the acquired and relinquished property are subject to MACRS in the hands of the acquiring taxpayer. These final regulations will affect taxpayers involved in a like-kind exchange under section 1031 or an involuntary conversion under section 1033. The corresponding temporary regulations are removed.

DATES: Effective Dates: These regulations are effective on February 26, 2007.

Applicability Dates: For dates of applicability, see §§1.168(a)-1(b), 1.168(b)-1(b), 1.168(d)-1(d)(3), 1.168(i)-1(l), 1.168(i)-6(k), and 1.168(k)-1(g)(3)(ii).

FOR FURTHER INFORMATION CONTACT: Patrick S. Kirwan, (202) 622-3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under section 168 of the Internal Revenue Code (Code). Section 168 provides the depreciation deduction for tangible property generally placed in service after December 31, 1986.

On March 1, 2004, the IRS and the Treasury Department published in the **Federal Register** (69 FR 9529) temporary regulations (TD 9115) relating to the depreciation allowable for tangible property of a character subject to the allowance for depreciation provided in section 167(a) that is generally placed in service after December 31, 1986, and is subject to section 168 (MACRS property) that is acquired in a like-kind exchange or as a result of involuntary conversion. On the same date the IRS published a notice of proposed rulemaking related to this topic in the **Federal Register** (69 FR 9560). No public hearing on the regulations was requested or held. Several written comments to the notice of proposed rulemaking were received. After consideration of all the comments received, the proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The revisions to the proposed regulations are discussed in this preamble. Unless otherwise specifically stated, references to the temporary regulations are to TD 9115.

General Overview

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for depreciable tangible property placed in service after 1986 generally is determined under section 168. Section 1001 generally provides for the recognition of gain or loss on the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized on an exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment. Section 1031(b) provides that if an exchange would be within the provision of section 1031(a) were it not for the fact that the property received in the exchange consists not only of property permitted to be received in such an exchange, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. Under section 1031(c), no loss from a transaction that also involves other property or money is recognized. Under section 1031(d), the basis of property acquired in an exchange described in section 1031 is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by the amount of gain (or decreased by the amount of loss) that was recognized on such exchange.

Section 1033(a)(1) provides that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, no gain is recognized. Under section 1033(b)(1), the

basis of property acquired by the taxpayer in such a transaction is the basis of the converted property. Under section 1033(a)(2)(A), if property is compulsorily or involuntarily converted into money or into property not similar or related in service or use to the converted property, and, within the time frame described in section 1033(a)(2)(B), the taxpayer purchases other property that is related in service or use to the converted property or purchases stock in the acquisition of control of a corporation owning such property, then the taxpayer may elect to recognize gain only to the extent that the amount realized upon such conversion exceeds the cost of such other property or stock. Under section 1033(b)(2), if such an election is made, the basis of the replacement property acquired by the taxpayer generally is the cost of that property decreased by any gain not recognized by reason of section 1033(a)(2).

Summary of Comments and Explanation of Provisions

Scope

In general, the final regulations adopt the rules outlined in the proposed and temporary regulations with the addition of some clarifying language and examples provided in response to comments. The temporary regulations provided guidance as to how to determine the annual depreciation allowance under section 168 for replacement property acquired in a like-kind exchange or involuntary conversion. However, the temporary regulations did not apply to a like-kind exchange or involuntary conversion if the allowance for depreciation of either the relinquished or replacement property is computed under a depreciation system other than section 168 (MACRS), or for which a taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS. A commentator requested that the final regulations apply to all property

acquired in a like-kind exchange or involuntary conversion. However, it is anticipated that the vast majority of like-kind exchanges and involuntary conversions occurring after the effective date of the final regulations will involve the exchange of MACRS property. In addition, there are differences between MACRS and other depreciation systems which would require the creation of additional rules which would only apply in a limited number of circumstances. Furthermore, certain types of property are statutorily excluded from being treated as MACRS property. Therefore, the final regulations do not adopt the commentator's suggestion. However, the final regulations allow a taxpayer to elect to treat the sum of the exchanged basis and excess basis of the replacement property as MACRS property that is placed in service at the time of replacement if the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS. For example, a taxpayer that exchanges a machine depreciated under the unit of production method for a used machine may depreciate under MACRS the sum of the exchanged basis and excess basis of the used machine (replacement property) as a machine placed in service at the time of replacement.

Optional Depreciation Tables

For taxpayers who wish to use the optional depreciation tables to determine the depreciation allowances for the replacement MACRS property instead of the formulas (for example, see section 6 of Rev. Proc. 87-57 (1987-2 CB 687, 692)), the final regulations provide guidance on choosing the applicable optional table as well as how to modify the calculation for computing the depreciation allowances for the replacement

MACRS property. A commentator noted that under the temporary regulations depreciation computed using the optional tables could be different than the depreciation computed using the formulas and suggested adopting a different transaction coefficient. The IRS and Treasury recognize that use of the optional depreciation tables may result in a different computation of depreciation. Nonetheless, the optional depreciation tables are intended to provide an alternative method of calculating depreciation for taxpayers. Furthermore, the transaction coefficient formula provided in the temporary regulations is consistent with transaction coefficient formulas provided in other depreciation guidance. Therefore, the final regulations retain the rules provided in the temporary regulations.

Depreciation Convention Provisions

Several comments were received about the application of the depreciation convention provisions under the temporary regulations. In response to these comments, several changes were made in the final regulations. Section 1.168(i)-6(c)(5)(ii)(A) was added in order to provide an explanation of the applicable convention separate from the explanation of the rule for determining the remaining recovery period for the replacement MACRS property. Section 1.168(i)-6(c)(4)(v) specifically addresses the convention that applies to the exchanged basis when the year of replacement is after the year of disposition and the relinquished MACRS property was placed in service in the year of disposition. Section 1.168(i)-6(c)(5)(i)(B) of the final regulations contains a new rule that provides that if, using the convention that applies to the relinquished MACRS property, the remaining recovery period of the relinquished MACRS property at the beginning of the year of disposition is less than the number of months between the first of that year and the time of disposition, the entire

basis in the relinquished MACRS property is deductible in the year of disposition and the exchanged basis is zero. In light of this new rule, Example 4 of §1.168(i)-6T(c)(6) of the temporary regulations has been replaced by Example 5 of §1.168(i)-6(c)(6).

Deferred Exchanges

The temporary regulations did not permit a taxpayer to take depreciation on relinquished MACRS property during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. A comment was received which noted that under the half-year convention if relinquished MACRS property is disposed of in year 1 and the replacement MACRS property is not acquired until year 2, the taxpayer would only be entitled to deduct a half-year of depreciation in each year. The IRS and Treasury Department recognize that this result could occur under the convention rules. However, similar results occur when property is disposed of and replaced in a transaction to which section 1031 or section 1033 do not apply. In addition, the IRS and Treasury Department believe that a taxpayer cannot depreciate property the taxpayer does not own. Therefore, the final regulations retain the rule provided in the temporary regulations with respect to this issue. The final regulations reserve on providing specific guidance as to whether an intermediary (such as an exchange accommodation titleholder) is entitled to depreciation.

Acquisition Prior to Disposition for an Involuntary Conversion

The temporary regulations allowed taxpayers to begin depreciating replacement property upon acquisition even if the acquisition occurs prior the disposition of the relinquished property if the replacement property is acquired to meet the requirements of section 1033(a)(2)(B) (acquisition under threat of condemnation). However, the

temporary regulations also required taxpayers to include in taxable income any excess depreciation allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation allowable on the excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer to the time of disposition of the relinquished MACRS property. A comment was received suggesting that taxpayers be permitted to reduce the exchanged basis of the replacement property by the excess depreciation rather than requiring a taxpayer to recognize the excess depreciation as taxable income. This suggestion was not adopted in the final regulations because it would have the effect of inappropriately accelerating depreciation deductions for the replacement property.

Exchanges of Multiple Properties

The determination of the basis of property acquired in a like-kind exchange involving multiple properties is described in §1.1031(j)-1 and the determination of the basis of multiple properties acquired as a result of an involuntary conversion is described in §1.1033(b)-1. Commentators requested examples to show how the temporary regulations apply to the depreciation treatment of a like-kind exchange or an involuntary conversion involving multiple properties. Other commentators suggested that taxpayers be permitted to use any reasonable, consistent method of allocating basis among the properties. The IRS and Treasury Department believe that these comments concern the allocation of basis principles under sections 1031 and 1033, rather than the depreciation rules under section 168. Once basis in property is determined or allocated under section 1031 or section 1033, these final regulations would then apply for determining the depreciation allowable with respect to such basis.

The IRS and Treasury Department believe that issues related to allocation of basis among multiple properties involved in like-kind exchanges or involuntary conversions for purposes of depreciation are beyond the scope of the final regulations. Therefore the final regulations do not address these issues. However, the IRS and Treasury Department intend to invite interested parties to submit written comments regarding whether additional published guidance is needed in this area, and to invite written comments that specifically propose or address possible resolutions to these issues.

Transactions Involving Nondepreciable Property

A commentator requested guidance as to how depreciation is calculated if the relinquished property was only partially used for business purposes. In response to this comment, the final regulations provide an example to show how depreciation is calculated on replacement property received in exchange for property that was used only partially for business purposes (see Example 2 in §1.168(i)-6(d)(3)(iii)).

General Asset Accounts

Under the temporary regulations, general asset account treatment terminates for the relinquished MACRS property as of the first day of the year of disposition. Because this rule would require taxpayers to track each property in a general asset account, the IRS and Treasury Department requested comments on alternative methods to account for a like-kind exchange or involuntary conversion involving MACRS property contained in a general asset account when the replacement MACRS property has a longer recovery period or less accelerated depreciation method than the relinquished MACRS property or when the basis of the general asset account would change as a result of the like-kind exchange or involuntary conversion. No comments were received on this rule

and no alternatives were suggested. Therefore, the regulations are adopted as proposed.

Effective Date

These final regulations generally apply to a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may apply these final regulations or rely on prior guidance issued by the IRS.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose a collection of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Patrick S. Kirwan, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other

personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 1.168(a)-1 and 1.168(b)-1 are added to read as follows:

§1.168(a)-1 Modified accelerated cost recovery system.

(a) Section 168 determines the depreciation allowance for tangible property that is of a character subject to the allowance for depreciation provided in section 167(a) and that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143). Except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule, the provisions of section 168 are mandatory for all eligible property. The allowance for depreciation under section 168 constitutes the amount of depreciation allowable under section 167(a). The determination of whether tangible property is property of a character subject to the allowance for depreciation is made under section 167 and the regulations under section 167.

(b) This section is applicable on and after February 27, 2004.

§1.168(b)-1 Definitions.

(a) Definitions. For purposes of section 168 and the regulations under section 168, the following definitions apply:

(1) Depreciable property is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations under section 167.

(2) MACRS property is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(3) Unadjusted depreciable basis is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, section 179C, or any similar provision, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Code (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(4) Adjusted depreciable basis is the unadjusted depreciable basis of the property, as defined in §1.168(b)-1(a)(3), less the adjustments described in section 1016(a)(2) and (3).

(b) Effective date. This section is applicable on or after February 27, 2004.

§§1.168(a)-1T and 1.168(b)-1T [Removed]

Par. 3. Sections 1.168(a)-1T and 1.168(b)-1T are removed.

Par. 4. Section 1.168(d)-1 is amended by revising the section heading and paragraphs (b)(3) and (d)(3) to read as follows:

§1.168(d)-1 Applicable conventions—half-year and mid-quarter conventions.

* * * * *

(b) * * *

(3) Property placed in service and disposed of in the same taxable year. (i)

Under section 168(d)(3)(B)(ii), the depreciable basis of property placed in service and disposed of in the same taxable year is not taken into account in determining whether the 40-percent test is satisfied. However, the depreciable basis of property placed in service, disposed of, subsequently reacquired, and again placed in service, by the taxpayer in the same taxable year must be taken into account in applying the 40-percent test, but the basis of the property is only taken into account on the later of the dates that the property is placed in service by the taxpayer during the taxable year. Further, see §§1.168(i)-6(c)(4)(v)(B) and 1.168(i)-6(f) for rules relating to property placed in service and exchanged or involuntarily converted during the same taxable year.

(ii) The applicable convention, as determined under this section, applies to all depreciable property (except nonresidential real property, residential rental property, and any railroad grading or tunnel bore) placed in service by the taxpayer during the taxable year, excluding property placed in service and disposed of in the same taxable

year. However, see §§1.168(i)-6(c)(4)(v)(A) and 1.168(i)-6(f) for rules relating to MACRS property that has a basis determined under section 1031(d) or section 1033(b). No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year. However, see §1.168(k)-1(f)(1) for rules relating to qualified property or 50-percent bonus depreciation property, and §1.1400L(b)-1(f)(1) for rules relating to qualified New York Liberty Zone property, that is placed in service by the taxpayer in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7).

* * * * *

(d) * * *

(3) Like-kind exchanges and involuntary conversions. The last sentence in paragraph (b)(3)(i) and the second sentence in paragraph (b)(3)(ii) of this section apply to exchanges to which section 1031 applies, and involuntary conversions to which section 1033 applies, of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004.

§1.168(d)-1T [Removed]

Par. 5. Section 1.168(d)-1T is removed.

Par. 6. Section 1.168(i)-0 is amended as follows:

1. The entries for §1.168(i)-1(d)(2), (e)(3)(i), (e)(3)(v), (e)(3)(vi), (f), (f)(1), (f)(2), (f)(2)(i), (i), (j), and (l) are revised.
2. The entries for §1.168(i)-1(l)(1), (l)(2), and (l)(3) are added.

The revisions and additions read as follows:

§1.168(i)-0 Table of contents for the general asset account rules.

* * * * *

§1.168(i)-1 General asset accounts.

* * * * *

(d) * * *

(2) Special rule for passenger automobiles.

* * * * *

(e) * * *

(3) * * *

(i) In general.

* * * * *

(v) Transactions subject to section 1031 or 1033.

(vi) Anti-abuse rule.

* * * * *

(f) Assets generating foreign source income.

(1) In general.

(2) Source of ordinary income, gain, or loss.

(i) Source determined by allocation and apportionment of depreciation allowed.

* * * * *

(i) Identification of disposed or converted asset.

(j) Effect of adjustments on prior dispositions.

* * * * *

(l) Effective date.

(1) In general.

(2) Exceptions.

(3) Like-kind exchanges and involuntary conversions.

§1.168(i)-0T [Removed]

Par. 7. Section 1.168(i)-0T is removed.

Par. 8. Section 1.168(i)-1 is amended as follows:

1. Paragraphs (d)(2), (e)(3)(i), (e)(3)(iii)(B)(4), (e)(3)(v), (e)(3)(vi), (f)(1), (f)(2)(i), (i), (j), (l)(1), and (l)(3) are revised.
2. The first sentence in paragraph (l)(2)(ii)(B) is amended by removing the language “as modified by Rev. Proc. 2004-11 (2004-3 I.R.B. 311)”.

The revisions read as follows:

§1.168(i)-1 General asset accounts.

* * * * *

(d) * * *

(2) Special rule for passenger automobiles. For purposes of applying section 280F(a), the depreciation allowance for a general asset account established for passenger automobiles is limited for each taxable year to the amount prescribed in section 280F(a) multiplied by the excess of the number of automobiles originally included in the account over the number of automobiles disposed of during the taxable year or in any prior taxable year in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv) (transactions subject to section 168(i)(7)), (e)(3)(v) (transactions subject to section 1031 or 1033), (e)(3)(vi) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(e) * * *

(3) * * *

(i) In general. This paragraph (e)(3) provides the rules for terminating general asset account treatment upon certain dispositions. While the rules under paragraphs (e)(3)(ii) and (iii) of this section are optional rules, the rules under paragraphs (e)(3)(iv), (v), and (vi) of this section are mandatory rules. A taxpayer applies paragraph (e)(3)(ii) or (iii) of this section by reporting the gain, loss, or other deduction on the taxpayer's timely filed Federal income tax return (including extensions) for the taxable year in which the disposition occurs. For purposes of applying paragraph (e)(3)(iii) through (vi)

of this section, see paragraph (i) of this section for identifying the unadjusted depreciable basis of a disposed asset.

* * * * *

(iii) * * *

(B) * * *

(4) A transaction, other than a transaction described in paragraphs (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)) and (e)(3)(v) (pertaining to transactions subject to section 1031 or 1033) of this section, to which a nonrecognition section of the Code applies (determined without regard to this section).

* * * * *

(v) Transactions subject to section 1031 or section 1033--(A) Like-kind exchange or involuntary conversion of all assets remaining in a general asset account. If all the assets, or the last asset, in a general asset account are transferred by a taxpayer in a like-kind exchange (as defined under §1.168-6(b)(11)) or in an involuntary conversion (as defined under §1.168-6(b)(12)), the taxpayer must apply this paragraph (e)(3)(v)(A) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(A), the general asset account terminates as of the first day of the year of disposition (as defined in §1.168(i)-6(b)(5)) and--

(1) The amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of disposition (as defined in §1.168(i)-6(b)(3)). The depreciation allowance for the general asset account in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished

MACRS property (as defined in §1.168(i)-6(b)(2)) in the year of disposition is determined under §1.168(i)-6. The recognition and character of gain or loss are determined in accordance with paragraph (e)(3)(ii)(A) of this section (notwithstanding that paragraph (e)(3)(ii) of this section is an optional rule); and

(2) The adjusted depreciable basis of the general asset account at the time of disposition is treated as the adjusted depreciable basis of the relinquished MACRS property.

(B) Like-kind exchange or involuntary conversion of less than all assets remaining in a general asset account. If an asset in a general asset account is transferred by a taxpayer in a like-kind exchange or in an involuntary conversion and if paragraph (e)(3)(v)(A) of this section does not apply to this asset, the taxpayer must apply this paragraph (e)(3)(v)(B) (instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section). Under this paragraph (e)(3)(v)(B), general asset account treatment for the asset terminates as of the first day of the year of disposition (as defined in §1.168(i)-6(b)(5)), and--

(1) The amount of gain or loss for the asset is determined by taking into account the asset's adjusted basis at the time of disposition (as defined in §1.168(i)-6(b)(3)). The adjusted basis of the asset at the time of disposition equals the unadjusted depreciable basis of the asset less the depreciation allowed or allowable for the asset, computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included. The depreciation allowance for the asset in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in

§1.168(i)-6(b)(2)) in the year of disposition is determined under §1.168(i)-6. The recognition and character of the gain or loss are determined in accordance with paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii) of this section is an optional rule); and

(2) As of the first day of the year of disposition, the taxpayer must remove the relinquished asset from the general asset account and make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(2) through (4) of this section.

(vi) Anti-abuse rule--(A) In general. If an asset in a general asset account is disposed of by a taxpayer in a transaction described in paragraph (e)(3)(vi)(B) of this section, general asset account treatment for the asset terminates as of the first day of the taxable year in which the disposition occurs. Consequently, the taxpayer must determine the amount of gain, loss, or other deduction attributable to the disposition in the manner described in paragraph (e)(3)(iii)(A) of this section (notwithstanding that paragraph (e)(3)(iii)(A) of this section is an optional rule) and must make the adjustments to the general asset account described in paragraph (e)(3)(iii)(C)(1) through (4) of this section.

(B) Abusive transactions. A transaction is described in this paragraph (e)(3)(vi)(B) if the transaction is not described in paragraph (e)(3)(iv) or (e)(3)(v) of this section and the transaction is entered into, or made, with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. Examples of these types of transactions include--

(1) A transaction entered into with a principal purpose of shifting income or deductions among taxpayers in a manner that would not be possible absent an election under this section in order to take advantage of differing effective tax rates among the taxpayers; or

(2) An election made under this section with a principal purpose of disposing of an asset from a general asset account in order to utilize an expiring net operating loss or credit. The fact that a taxpayer with a net operating loss carryover or a credit carryover transfers an asset to a related person or transfers an asset pursuant to an arrangement where the asset continues to be used (or is available for use) by the taxpayer pursuant to a lease (or otherwise) indicates, absent strong evidence to the contrary, that the transaction is described in this paragraph (e)(3)(vi)(B).

(f) * * *

(1) In general. This paragraph (f) provides the rules for determining the source of any income, gain, or loss recognized, and the appropriate section 904(d) separate limitation category or categories for any foreign source income, gain, or loss recognized, on a disposition (within the meaning of paragraph (e)(1) of this section) of an asset in a general asset account that consists of assets generating both United States and foreign source income. These rules apply only to a disposition to which paragraph (e)(2) (general disposition rules), (e)(3)(ii) (disposition of all assets remaining in a general asset account), (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(v) (transactions subject to section 1031 or 1033), or (e)(3)(vi) (anti-abuse rule) of this section applies.

(2) * * *

(i) Source determined by allocation and apportionment of depreciation allowed.

The amount of any ordinary income, gain, or loss that is recognized on the disposition of an asset in a general asset account must be apportioned between United States and foreign sources based on the allocation and apportionment of the--

(A) Depreciation allowed for the general asset account as of the end of the taxable year in which the disposition occurs if paragraph (e)(2) of this section applies to the disposition;

(B) Depreciation allowed for the general asset account as of the time of disposition if the taxpayer applies paragraph (e)(3)(ii) of this section to the disposition of all assets, or the last asset, in the general asset account, or if all the assets, or the last asset, in the general asset account are disposed of in a transaction described in paragraph (e)(3)(v)(A) of this section; or

(C) Depreciation allowed for the disposed asset for only the taxable year in which the disposition occurs if the taxpayer applies paragraph (e)(3)(iii) of this section to the disposition of the asset in a qualifying disposition, if the asset is disposed of in a transaction described in paragraph (e)(3)(v)(B) of this section (like-kind exchange or involuntary conversion), or if the asset is disposed in a transaction described in paragraph (e)(3)(vi) of this section (anti-abuse rule).

* * * * *

(i) * * * A taxpayer may use any reasonable method that is consistently applied to the taxpayer's general asset accounts for purposes of determining the unadjusted depreciable basis of a disposed or converted asset in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), (e)(3)(iv)

(transactions subject to section 168(i)(7)), (e)(3)(v) (transactions subject to section 1031 or 1033), (e)(3)(vi) (anti-abuse rule), (g) (assets subject to recapture), or (h)(1) (conversion to personal use) of this section.

(j) Effect of adjustments on prior dispositions. The adjustments to a general asset account under paragraph (e)(3)(iii), (e)(3)(iv), (e)(3)(v), (e)(3)(vi), (g), or (h)(1) of this section have no effect on the recognition and character of prior dispositions subject to paragraph (e)(2) of this section.

* * * * *

(l) * * *

(1) In general. Except as provided in paragraphs (l)(2) and (l)(3) of this section, this section applies to depreciable assets placed in service in taxable years ending on or after October 11, 1994. For depreciable assets placed in service after December 31, 1986, in taxable years ending before October 11, 1994, the Internal Revenue Service will allow any reasonable method that is consistently applied to the taxpayer's general asset accounts.

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(3) Like-kind exchanges and involuntary conversions. This section applies for an asset transferred by a taxpayer in a like-kind exchange (as defined under §1.168-6(b)(11)) or in an involuntary conversion (as defined under §1.168-6(b)(12)) for which the time of disposition (as defined in §1.168(i)-6(b)(3)) and the time of replacement (as defined in §1,168(i)-6(b)(4)) both occur after February 27, 2004. For an asset transferred by a taxpayer in a like-kind exchange or in an involuntary conversion for which the time of disposition, the time of replacement, or both occur on or before

February 27, 2004, see §1.168(i)-1 in effect prior to February 27, 2004 (§1.168(i)-1 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

§1.168(i)-1T [Removed]

Par. 9. Section 1.168(i)-1T is removed.

Par. 10. Section 1.168(i)-5 is added to read as follows:

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This section lists the major paragraphs contained in §1.168(i)-6.

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§1.168(i)-5T [Removed]

Par. 11. Section 1.168(i)-5T is removed.

Par. 12. Section 1.168(i)-6 is added to read as follows:

§1.168(i)-6 Like-kind exchanges and involuntary conversions.

(a) Scope. This section provides the rules for determining the depreciation allowance for MACRS property acquired in a like-kind exchange or an involuntary conversion, including a like-kind exchange or an involuntary conversion of MACRS property that is exchanged or replaced with other MACRS property in a transaction between members of the same affiliated group. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of replacement and any subsequent taxable year for the replacement MACRS property and for the year of disposition of the relinquished MACRS property. The provisions of this section apply only to MACRS property to which §1.168(h)-1 (like-kind exchanges of tax-exempt use property) does not apply. Additionally, paragraphs (c)

through (f) of this section apply only to MACRS property for which an election under paragraph (i) of this section has not been made.

(b) Definitions. For purposes of this section, the following definitions apply:

(1) Replacement MACRS property is MACRS property (as defined in §1.168(b)-1(a)(2)) in the hands of the acquiring taxpayer that is acquired for other MACRS property in a like-kind exchange or an involuntary conversion.

(2) Relinquished MACRS property is MACRS property that is transferred by the taxpayer in a like-kind exchange, or in an involuntary conversion.

(3) Time of disposition is when the disposition of the relinquished MACRS property takes place under the convention, as determined under §1.168(d)-1, that applies to the relinquished MACRS property.

(4) Time of replacement is the later of--

(i) When the replacement MACRS property is placed in service under the convention, as determined under this section, that applies to the replacement MACRS property; or

(ii) The time of disposition of the exchanged or involuntarily converted property.

(5) Year of disposition is the taxable year that includes the time of disposition.

(6) Year of replacement is the taxable year that includes the time of replacement.

(7) Exchanged basis is determined after the depreciation deductions for the year of disposition are determined under paragraph (c)(5)(i) of this section and is the lesser of--

(i) The basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the

regulations under section 1033(b); or

(ii) The adjusted depreciable basis (as defined in §1.168(b)-1(a)(4)) of the relinquished MACRS property.

(8) Excess basis is any excess of the basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b), over the exchanged basis as determined under paragraph (b)(7) of this section.

(9) Depreciable exchanged basis is the exchanged basis as determined under paragraph (b)(7) of this section reduced by--

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(ii) Any adjustments to basis provided by other provisions of the Internal Revenue Code (Code) and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(10) Depreciable excess basis is the excess basis as determined under paragraph (b)(8) of this section reduced by--

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(ii) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179; and

(iii) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(11) Like-kind exchange is an exchange of property in a transaction to which section 1031(a)(1), (b), or (c) applies.

(12) Involuntary conversion is a transaction described in section 1033(a)(1) or (2) that resulted in the nonrecognition of any part of the gain realized as the result of the conversion.

(c) Determination of depreciation allowance--(1) Computation of the depreciation allowance for depreciable exchanged basis beginning in the year of replacement--(i) In general. This paragraph (c) provides rules for determining the applicable recovery period, the applicable depreciation method, and the applicable convention used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement. See paragraph (c)(5) of this section for rules relating to the computation of the depreciation allowance for the year of disposition and for the year of replacement. See paragraph (d)(1) of this section for rules relating to the computation of the depreciation allowance for depreciable excess basis. See paragraph (d)(4) of this section if the replacement MACRS property is acquired before disposition of the relinquished MACRS property in a transaction to which section 1033 applies. See paragraph (e) of this section for rules relating to the computation of the depreciation allowance using the optional depreciation tables.

(ii) Applicable recovery period, depreciation method, and convention. The

recovery period, depreciation method, and convention determined under this paragraph (c) are the only permissible methods of accounting for MACRS property within the scope of this section unless the taxpayer makes the election under paragraph (i) of this section not to apply this section.

(2) Effect of depreciation treatment of the replacement MACRS property by previous owners of the acquired property. If replacement MACRS property is acquired by a taxpayer in a like-kind exchange or an involuntary conversion, the depreciation treatment of the replacement MACRS property by previous owners has no effect on the determination of depreciation allowances for the replacement MACRS property in the hands of the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property for property that was depreciated under section 168 of the Internal Revenue Code of 1954 (ACRS) by the previous owner must use this section because the replacement property will become MACRS property in the hands of the acquiring taxpayer. In addition, elections made by previous owners in determining depreciation allowances for the replacement MACRS property have no effect on the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property that the taxpayer depreciates under the general depreciation system of section 168(a) for other MACRS property that the previous owner elected to depreciate under the alternative depreciation system pursuant to section 168(g)(7) does not have to continue using the alternative depreciation system for the replacement MACRS property.

(3) Recovery period and/or depreciation method of the properties are the same, or both are not the same--(i) In general. For purposes of paragraphs (c)(3) and (c)(4) of

this section in determining whether the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under section 168 for the relinquished MACRS property, the recovery period and the depreciation method for the replacement MACRS property are considered to be the recovery period and the depreciation method that would have applied under section 168, taking into account any elections made by the acquiring taxpayer under section 168(b)(5) or 168(g)(7), had the replacement MACRS property been placed in service by the acquiring taxpayer at the same time as the relinquished MACRS property.

(ii) Both the recovery period and the depreciation method are the same. If both the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined by using the same recovery period and depreciation method that were used for the relinquished MACRS property. Thus, the replacement MACRS property is depreciated over the remaining recovery period (taking into account the applicable convention), and by using the depreciation method, of the relinquished MACRS property. Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning with the year of replacement are determined by multiplying the depreciable exchanged basis by the applicable depreciation rate for each taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87-57 (1987-2 CB 687,

692) and §601.601(d)(2)(ii)(b) of this chapter).

(iii) Either the recovery period or the depreciation method is the same, or both are not the same. If either the recovery period or the depreciation method prescribed under section 168 for the replacement MACRS property is the same as the recovery period or the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the recovery period or the depreciation method that is the same as the relinquished MACRS property. See paragraph (c)(4) of this section to determine the depreciation allowances when the recovery period or the depreciation method of the replacement MACRS property is not the same as that of the relinquished MACRS property.

(4) Recovery period or depreciation method of the properties is not the same. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the recovery period prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined under this paragraph (c)(4). Similarly, if the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation method used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement is determined under this paragraph (c)(4).

(i) Longer recovery period. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is longer than that prescribed for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer in the same taxable year the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the longer recovery period of the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) and the convention determined under paragraph (c)(4)(v) of this section. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the replacement MACRS property.

(ii) Shorter recovery period. If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is shorter than that of the relinquished MACRS 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 MACRS property. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the relinquished MACRS property.

(iii) Less accelerated depreciation method--(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is less accelerated than that of the relinquished

MACRS property at the time of disposition, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the less accelerated depreciation method. Thus, the depreciable exchanged basis is depreciated using the less accelerated depreciation method.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the replacement MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the relinquished MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is determined by using the depreciation rate of the replacement MACRS property as if the replacement MACRS property was placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method of the replacement MACRS property is the straight line method, the applicable depreciation rate for the year of replacement is

determined by using the remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(iv) More accelerated depreciation method--(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is more accelerated than that of the relinquished MACRS property at the time of disposition, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined using the same depreciation method as the relinquished MACRS property.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the relinquished MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the replacement MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is the same depreciation rate that applied to the relinquished MACRS property in the year of replacement, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method is the straight line method, the applicable depreciation rate for the year of replacement is determined by using the

remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(v) Convention. The applicable convention for the exchanged basis is determined under this paragraph (c)(4)(v).

(A) Either the relinquished MACRS property or the replacement MACRS property is mid-month property. If either the relinquished MACRS property or the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the exchanged basis must be depreciated using the mid-month convention.

(B) Neither the relinquished MACRS property nor the replacement MACRS property is mid-month property. If neither the relinquished MACRS property nor the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the applicable convention for the exchanged basis is the same convention that applied to the relinquished MACRS property. If the relinquished MACRS property is placed in service in the year of disposition, and the time of replacement is also in the year of disposition, the convention that applies to the relinquished MACRS property is determined under paragraph (f)(1)(i) of this section. If, however, relinquished MACRS property was placed in service in the year of disposition and the time of replacement is in a taxable year subsequent to the year of disposition, the convention that applies to the exchanged basis is the convention that applies in that subsequent taxable year (see paragraph (f)(1)(ii) of this section).

(5) Year of disposition and year of replacement. No depreciation deduction is

allowable for MACRS property disposed of by a taxpayer in a like-kind exchange or involuntary conversion in the same taxable year that such property was placed in service by the taxpayer. If replacement MACRS property is disposed of by a taxpayer during the same taxable year that the relinquished MACRS property is placed in service by the taxpayer, no depreciation deduction is allowable for either MACRS property. Otherwise, the depreciation allowances for the year of disposition and for the year of replacement are determined as follows:

(i) Relinquished MACRS property--(A) General rule. Except as provided in paragraphs (c)(5)(i)(B), (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of disposition for the relinquished MACRS property is computed by multiplying the allowable depreciation deduction for the property for that year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of disposition (taking into account the applicable convention of the relinquished MACRS property), and the denominator of which is 12. In the case of termination under §1.168(i)-1(e)(3)(v) of general asset account treatment of an asset, or of all the assets remaining, in a general asset account, the allowable depreciation deduction in the year of disposition for the asset or assets for which general asset account treatment is terminated is determined using the depreciation method, recovery period, and convention of the general asset account. This allowable depreciation deduction is adjusted to account for the period the asset or assets is deemed to be in service in accordance with this paragraph (c)(5)(i).

(B) Special rule. If, at the beginning of the year of disposition, the remaining recovery period of the relinquished MACRS property, taking into account the applicable

convention of such property, is less than the period between the beginning of the year of disposition and the time of disposition, the depreciation deduction for the relinquished MACRS property for the year of disposition is equal to the adjusted depreciable basis of the relinquished MACRS property at the beginning of the year of disposition. If this paragraph applies, the exchanged basis is zero and no depreciation is allowable for the exchanged basis in the replacement MACRS property.

(ii) Replacement MACRS property--(A) Remaining recovery period of the replacement MACRS property. The replacement MACRS property is treated as placed in service at the time of replacement under the convention that applies to the replacement MACRS property as determined under this paragraph (c)(5)(ii). The remaining recovery period of the replacement MACRS property at the time of replacement is the excess of the recovery period for the replacement MACRS property, as determined under paragraph (c) of this section, over the period of time that the replacement MACRS property would have been in service if it had been placed in service when the relinquished MACRS property was placed in service and removed from service at the time of disposition of the relinquished MACRS property. This period is determined by using the convention that applied to the relinquished MACRS property to determine the date that the relinquished MACRS property is deemed to have been placed in service and the date that it is deemed to have been disposed of. The length of time the replacement MACRS property would have been in service is determined by using these dates and the convention that applies to the replacement MACRS property.

(B) Year of replacement is 12 months. Except as provided in paragraphs (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of

replacement for the depreciable exchanged basis is determined by--

(1) Calculating the applicable depreciation rate for the replacement MACRS property as of the beginning of the year of replacement taking into account the depreciation method prescribed for the replacement MACRS property under paragraph (c)(3) of this section and the remaining recovery period of the replacement MACRS property as of the beginning of the year of disposition as determined under this paragraph (c)(5)(ii);

(2) Calculating the depreciable exchanged basis of the replacement MACRS property, and adding to that amount the amount determined under paragraph (c)(5)(i) of this section for the year of disposition; and

(3) Multiplying the product of the amounts determined under paragraphs (c)(5)(ii)(B)(1) and (B)(2) of this section by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the year of replacement (in the year of replacement the replacement MACRS property is deemed to be placed in service by the acquiring taxpayer at the time of replacement under the convention determined under paragraph (c)(4)(v) of this section), and the denominator of which is 12.

(iii) Year of disposition or year of replacement is less than 12 months. If the year of disposition or the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (c)(5)(ii)(A) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 CB 816) and §601.601(d)(2)(ii)(b) of this chapter).

(iv) Deferred transactions--(A) In general. If the replacement MACRS property is

not acquired until after the disposition of the relinquished MACRS property, taking into account the applicable convention of the relinquished MACRS property and replacement MACRS property, depreciation is not allowable during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. The recovery period for the replacement MACRS property is suspended during this period. For purposes of paragraph (c)(5)(ii) of this section, only the depreciable exchanged basis of the replacement MACRS property is taken into account for calculating the amount in paragraph (c)(5)(ii)(B)(2) of this section if the year of replacement is a taxable year subsequent to the year of disposition.

(B) Allowable depreciation for a qualified intermediary. [Reserved].

(v) Remaining recovery period. The remaining recovery period of the replacement MACRS property is determined as of the beginning of the year of disposition of the relinquished MACRS property. For purposes of determining the remaining recovery period of the replacement MACRS property, the replacement MACRS property is deemed to have been originally placed in service under the convention determined under paragraph (c)(4)(v) of this section but at the time the relinquished MACRS property was deemed to be placed in service under the convention that applied to it when it was placed in service.

(6) Examples. The application of this paragraph (c) is illustrated by the following examples:

Example 1. A1, a calendar-year taxpayer, exchanges Building M, an office building, for Building N, a warehouse in a like-kind exchange. Building M is relinquished in July 2004 and Building N is acquired and placed in service in October 2004. A1 did not make any elections under section 168 for either Building M or Building N. The unadjusted depreciable basis of Building M was \$4,680,000 when placed in service in

July 1997. Since the recovery period and depreciation method prescribed under section 168 for Building N (39 years, straight line method) are the same as the recovery period and depreciation method prescribed under section 168 for Building M (39 years, straight line method), Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Applying the applicable convention, Building M is deemed disposed of on July 15, 2004, and Building N is placed in service on October 15, 2004. Thus, Building N will be depreciated using the straight line method over a remaining recovery period of 32 years beginning in October 2004 (the remaining recovery period of 32 years and 6.5 months at the beginning of 2004, less the 6.5 months of depreciation taken prior to the disposition of the exchanged MACRS property (Building M) in 2004). For 2004, the year in which the transaction takes place, the depreciation allowance for Building M is $(\$120,000)(6.5/12)$ which equals \$65,000. The depreciation allowance for Building N for 2004 is $(\$120,000)(2.5/12)$ which equals \$25,000. For 2005 and subsequent years, Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Thus, the depreciation allowance for Building N is the same as Building M, namely \$10,000 per month.

Example 2. B, a calendar-year taxpayer, placed in service Bridge P in January 1998. Bridge P is depreciated using the half-year convention. In January 2004, B exchanges Bridge P for Building Q, an apartment building, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, B decided to apply §1.168(i)-6 to the exchange of Bridge P for Building Q, the replacement MACRS property. B did not make any elections under section 168 for either Bridge P or Building Q. Since the recovery period prescribed under section 168 for Building Q (27.5 years) is longer than that of Bridge P (15 years), Building Q is depreciated as if it had originally been placed in service in July 1998 and disposed of in July 2004 using a 27.5 year recovery period. Additionally, since the depreciation method prescribed under section 168 for Building Q (straight line method) is less accelerated than that of Bridge P (150-percent declining balance method), then the depreciation allowance for Building Q is computed using the straight line method. Thus, when Building Q is acquired and placed in service in 2004, its basis is depreciated over the remaining 21.5 year recovery period using the straight line method of depreciation and the mid-month convention beginning in July 2004.

Example 3. C, a calendar-year taxpayer, placed in service Building R, a restaurant, in January 1996. In January 2004, C exchanges Building R for Tower S, a radio transmitting tower, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, C decided to apply §1.168(i)-6 to the exchange of Building R for Tower S, the replacement MACRS property. C did not make any elections under section 168 for either Building R or Tower S. Since the recovery period prescribed under section 168 for Tower S (15 years) is shorter than that of Building R (39 years), Tower S is depreciated over the remaining recovery period of Building R. Additionally, since the depreciation method prescribed under section 168 for Tower S (150% declining balance method) is more accelerated than that of Building R (straight line method), then the depreciation allowance for Tower S is also computed using the same depreciation

method as Building R. Thus, Tower S is depreciated over the remaining 31 year recovery period of Building R using the straight line method of depreciation and the mid-month convention. Alternatively, C may elect under paragraph (i) of this section to treat Tower S as though it is placed in service in January 2004. In such case, C uses the applicable recovery period, depreciation method, and convention prescribed under section 168 for Tower S.

Example 4. (i) In February 2002, D, a calendar-year taxpayer and manufacturer of rubber products, acquired for \$60,000 and placed in service Asset T (a special tool) and depreciated Asset T using the straight line method election under section 168(b)(5) and the mid-quarter convention over its 3-year recovery period. D elected not to deduct the additional first year depreciation for 3-year property placed in service in 2002. In June 2004, D exchanges Asset T for Asset U (not a special tool) in a like-kind exchange. D elected not to deduct the additional first year depreciation for 7-year property placed in service in 2004. Since the recovery period prescribed under section 168 for Asset U (7 years) is longer than that of Asset T (3 years), Asset U is depreciated as if it had originally been placed in service in February 2002 using a 7-year recovery period. Additionally, since the depreciation method prescribed under section 168 for Asset U (200-percent declining balance method) is more accelerated than that of Asset T (straight line method) at the time of disposition, the depreciation allowance for Asset U is computed using the straight line method. Asset U is depreciated over its remaining recovery period of 4.75 years using the straight line method of depreciation and the mid-quarter convention.

(ii) The 2004 depreciation allowance for Asset T is $\$7,500$ ($\$20,000$ allowable depreciation deduction for 2004) \times 4.5 months \div 12).

(iii) The depreciation rate in 2004 for Asset U is 0.1951 ($1 \div 5.125$ years (the length of the applicable recovery period remaining as of the beginning of 2004)). Therefore, the depreciation allowance for Asset U in 2004 is $\$2,744$ ($0.1951 \times \$22,500$ (the sum of the $\$15,000$ depreciable exchanged basis of Asset U ($\$22,500$ adjusted depreciable basis at the beginning of 2004 for Asset T, less the $\$7,500$ depreciation allowable for Asset T for 2004) and the $\$7,500$ depreciation allowable for Asset T for 2004) \times 7.5 months \div 12).

Example 5. The facts are the same as in Example 4 except that D exchanges Asset T for Asset U in June 2005, in a like-kind exchange. Under these facts, the remaining recovery period of Asset T at the beginning of 2005 is 1.5 months and, as a result, is less than the 5-month period between the beginning of 2005 (year of disposition) and June 2005 (time of disposition). Accordingly, pursuant to paragraph (c)(5)(i)(B) of this section, the 2005 depreciation allowance for Asset T is $\$2,500$ ($\$2,500$ adjusted depreciable basis at the beginning of 2005 ($\$60,000$ original basis minus $\$17,500$ depreciation deduction for 2002 minus $\$20,000$ depreciation deduction for 2003 minus $\$20,000$ depreciation deduction for 2004)). Because the exchanged basis of asset U is $\$0.00$ no depreciation is allowable for asset U.

Example 6. On January 1, 2004, E, a calendar-year taxpayer, acquired and placed in service Canopy V, a gas station canopy. The purchase price of Canopy V was \$60,000. On August 1, 2004, Canopy V was destroyed in a hurricane and was therefore no longer usable in E's business. On October 1, 2004, as part of the involuntary conversion, E acquired and placed in service new Canopy W with the insurance proceeds E received due to the loss of Canopy V. E elected not to deduct the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. The depreciation deduction allowable for Canopy W for 2004 is \$12,000 ($\$60,000 \times \text{the annual depreciation rate of } .40 \times \frac{1}{2} \text{ year}$). For 2005, the depreciation deduction for Canopy W is \$19,200 ($\$48,000 \text{ adjusted basis} \times \text{the annual depreciation rate of } .40$).

Example 7. The facts are the same as in Example 6, except that E did not make the election out of the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. For 2004, E is allowed a 50-percent additional first year depreciation deduction of \$30,000 for Canopy W (the unadjusted depreciable basis of \$60,000 multiplied by .50), and a regular MACRS depreciation deduction of \$6,000 for Canopy W (the depreciable exchanged basis of \$30,000 multiplied by the annual depreciation rate of $.40 \times \frac{1}{2} \text{ year}$). For 2005, E is allowed a regular MACRS depreciation deduction of \$9,600 for Canopy W (the depreciable exchanged basis of \$24,000 ($\$30,000 \text{ minus regular 2003 depreciation of } \$6,000$) multiplied by the annual depreciation rate of .40).

Example 8. In January 2001, F, a calendar-year taxpayer, places in service a paved parking lot, Lot W, and begins depreciating Lot W over its 15-year recovery period. F's unadjusted depreciable basis in Lot W is \$1,000x. On April 1, 2004, F disposes of Lot W in a like-kind exchange for Building X, which is nonresidential real property. Lot W is depreciated using the 150 percent declining balance method and the half-year convention. Building X is depreciated using the straight-line method with a 39-year recovery period and using the mid-month convention. Both Lot W and Building X were in service at the time of the exchange. Because Lot W was depreciated using the half-year convention, it is deemed to have been placed in service on July 1, 2001, the first day of the second half of 2001, and to have been disposed of on July 1, 2004, the first day of the second half of 2004. To determine the remaining recovery period of Building X at the time of replacement, Building X is deemed to have been placed in service on July 1, 2001, and removed from service on July 1, 2004. Thus, Building X is deemed to have been in service, at the time of replacement, for 3 years (36 months=5.5 months in 2001 + 12 months in 2002 + 12 months in 2003 + 6.5 months in 2004) and its

remaining recovery period is 36 years (39 - 3). Because Building X is deemed to be placed in service at the time of replacement, July 1, 2004, the first day of the second half of 2004, Building X is depreciated for 5.5 months in 2004. However, at the beginning of the year of replacement the remaining recovery period for Building X is 36 years and 6.5 months (39 years - 2 years and 5.5 months (5.5 months in 2001 + 12 months in 2002 + 12 months in 2003)). The depreciation rate for building X for 2004 is 0.02737 (= $1/(39-2-5.5/12)$). For 2005, the depreciation rate for Building X is 0.02814 (= $1/(39-3-5.5/12)$).

Example 9. The facts are the same as in Example 8. F did not make the election under paragraph (i) of this section for Building Y in the initial exchange. In January 2006, F exchanges Building Y for Building Z, an office building, in a like-kind exchange. F did not make any elections under section 168 for either Building Y or Building Z. Since the recovery period prescribed for Building Y as a result of the initial exchange (39 years) is longer than that of Building Z (27.5 years), Building Z is depreciated over the remaining 33 years of the recovery period of Building Y. The depreciation methods are the same for both Building Y and Building Z so F's exchanged basis in Building Z is depreciated over 33 years, using the straight-line method and the mid-month convention, beginning in January 2006. Alternatively, F could have made the election under paragraph (i) of this section. If F makes such election, Building Z is treated as placed in service by F when acquired in January 2006 and F would recover its exchanged basis in Building Z over 27.5 years, using the straight line method and the mid-month convention, beginning in January 2006.

(d) Special rules for determining depreciation allowances--(1) Excess basis--(i) In general. Any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the depreciable excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the property at the time of replacement. However, if replacement MACRS property is disposed of during the same taxable year the relinquished MACRS property is placed in service by the acquiring taxpayer, no depreciation deduction is allowable for either MACRS property. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(ii) Example. The application of this paragraph (d)(1) is illustrated by the following example :

Example. In 1989, G placed in service a hospital. On January 16, 2004, G exchanges this hospital plus \$2,000,000 cash for an office building in a like-kind exchange. On January 16, 2004, the hospital has an adjusted depreciable basis of \$1,500,000. After the exchange, the basis of the office building is \$3,500,000. Pursuant to paragraph (k)(2)(i) of this section, G decided to apply §1.168(i)-6 to the exchange of the hospital for the office building, the replacement MACRS property. The depreciable exchanged basis of the office building is depreciated in accordance with paragraph (c) of this section. The depreciable excess basis of \$2,000,000 is treated as being placed in service by G in 2004 and, as a result, is depreciated using the applicable depreciation method, recovery period, and convention prescribed for the office building under section 168 at the time of replacement.

(2) Depreciable and nondepreciable property--(i) If land or other nondepreciable property is acquired in a like-kind exchange for, or as a result of an involuntary conversion of, depreciable property, the land or other nondepreciable property is not depreciated. If both MACRS and nondepreciable property are acquired in a like-kind exchange for, or as part of an involuntary conversion of, MACRS property, the basis allocated to the nondepreciable property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is not depreciated and the basis allocated to the replacement MACRS property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is depreciated in accordance with this section.

(ii) If MACRS property is acquired, or if both MACRS and nondepreciable property are acquired, in a like-kind exchange for, or as part of an involuntary conversion of, land or other nondepreciable property, the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is

treated as though the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the replacement MACRS property are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(3) Depreciation limitations for automobiles--(i) In general. Depreciation allowances under section 179 and section 167 (including allowances under sections 168 and 1400L(b)) for a passenger automobile, as defined in section 280F(d)(5), are subject to the limitations of section 280F(a). The depreciation allowances for a passenger automobile that is replacement MACRS property (replacement MACRS passenger automobile) generally are limited in any taxable year to the replacement automobile section 280F limit for the taxable year. The taxpayer's basis in the replacement MACRS passenger automobile is treated as being comprised of two separate components. The first component is the exchanged basis and the second component is the excess basis, if any. The depreciation allowances for a passenger automobile that is relinquished MACRS property (relinquished MACRS passenger automobile) for the taxable year generally are limited to the relinquished automobile section 280F limit for that taxable year. In the year of disposition the sum of the depreciation deductions for the relinquished MACRS passenger automobile and the replacement MACRS passenger automobile may not exceed the replacement automobile section 280F limit unless the taxpayer makes the election under §1.168(i)-

6(i). For purposes of this paragraph (d)(3), the following definitions apply:

(A) Replacement automobile section 280F limit is the limit on depreciation deductions under section 280F(a) for the taxable year based on the time of replacement of the replacement MACRS passenger automobile (including the effect of any elections under section 168(k) or section 1400L(b), as applicable).

(B) Relinquished automobile section 280F limit is the limit on depreciation deductions under section 280F(a) for the taxable year based on when the relinquished MACRS passenger automobile was placed in service by the taxpayer.

(ii) Order in which limitations on depreciation under section 280F(a) are applied. Generally, depreciation deductions allowable under section 280F(a) reduce the basis in the relinquished MACRS passenger automobile and the exchanged basis of the replacement MACRS passenger automobile, before the excess basis of the replacement MACRS passenger automobile is reduced. The depreciation deductions for the relinquished MACRS passenger automobile in the year of disposition and the replacement MACRS passenger automobile in the year of replacement and each subsequent taxable year are allowable in the following order:

(A) The depreciation deduction allowable for the relinquished MACRS passenger automobile as determined under paragraph (c)(5)(i) of this section for the year of disposition to the extent of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit, if the year of disposition is the year of replacement. If the year of replacement is a taxable year subsequent to the year of disposition, the depreciation deduction allowable for the relinquished MACRS passenger automobile for the year of disposition is limited to the relinquished

automobile section 280F limit.

(B) The additional first year depreciation allowable on the remaining exchanged basis (remaining carryover basis as determined under §1.168(k)-1(f)(5) or §1.1400L(b)-1(f)(5), as applicable) of the replacement MACRS passenger automobile, as determined under §1.168(k)-1(f)(5) or §1.1400L(b)-1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the amount allowable under paragraph (d)(3)(ii)(A) of this section.

(C) The depreciation deduction allowable for the taxable year on the depreciable exchanged basis of the replacement MACRS passenger automobile determined under paragraph (c) of this section to the extent of any excess over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A) and (B) of this section of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit.

(D) Any section 179 deduction allowable in the year of replacement on the excess basis of the replacement MACRS passenger automobile to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), and (C) of this section.

(E) The additional first year depreciation allowable on the remaining excess basis of the replacement MACRS passenger automobile, as determined under §1.168(k)-1(f)(5) or §1.1400L(b)-1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), and (D) of this section.

(F) The depreciation deduction allowable under paragraph (d) of this section for

the depreciable excess basis of the replacement MACRS passenger automobile to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), (D), and (E) of this section.

(iii) Examples. The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. H, a calendar-year taxpayer, acquired and placed in service Automobile X in January 2000 for \$30,000 to be used solely for H's business. In December 2003, H exchanges, in a like-kind exchange, Automobile X plus \$15,000 cash for new Automobile Y that will also be used solely in H's business. Automobile Y is 50-percent bonus depreciation property for purposes of section 168(k)(4). Both automobiles are depreciated using the double declining balance method, the half-year convention, and a 5-year recovery period. Pursuant to §1.168(k)-1(g)(3)(ii) and paragraph (k)(2)(i) of this section, H decided to apply §1.168(i)-6 to the exchange of Automobile X for Automobile Y, the replacement MACRS property. The relinquished automobile section 280F limit for 2003 for Automobile X is \$1,775. The replacement automobile section 280F 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 section 280F into account, the additional first year depreciation deduction for the remaining exchanged basis is \$8,658 (\$17,315 x 0.5). Because this amount is less than \$8,935 (\$10,710 (the replacement automobile section 280F 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 section 280F limit. An additional first year depreciation deduction of \$277 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 \$14,723 (\$15,000 (excess basis) - \$277 (additional first year depreciation for 2003)).

Example 2. The facts are the same as in Example 1, except that H used Automobile X only 75 percent for business use. As such, the total allowable depreciation for Automobile X is reduced to reflect that the automobile is only used 75 percent for business. The total allowable depreciation of Automobile X is \$9,513.75 (\$2,295 for 2000 (\$3,060 limit x .75), \$3,675 for 2001 (\$4,900 limit x .75), \$2,212.50 for

2002 (\$2,950 limit x .75), and \$1,331.25 for 2003 (\$1,775 limit x .75). However, under §1.280F-2T(g)(2)(ii)(A), the exchanged basis is reduced by the excess (if any) of the depreciation that would have been allowable if the exchanged automobile had been used solely for business over the depreciation that was allowable in those years. Thus, the exchanged basis, for purposes of computing depreciation, for Automobile Y is \$17,315.

Example 3. The facts are the same as in Example 1, except that H placed in service Automobile X in January 2002, and H elected not to claim the additional first year depreciation deduction for 5-year property placed in service in 2002 and 2003. The relinquished automobile section 280F limit for Automobile X for 2003 is \$4,900. Because the replacement automobile section 280F limit for 2003 for Automobile Y (\$3,060) is less than the relinquished automobile section 280F limit for Automobile X for 2003 and is less than \$5,388 ($(\$30,000 \text{ (cost)} - \$3,060 \text{ (depreciation allowable for 2002)}) \times 0.4 \times 6/12$), the depreciation that would be allowable for Automobile X (determined without regard to section 280F) in the year of disposition, the depreciation for Automobile X in the year of disposition is limited to \$3,060. For 2003 no depreciation is allowable for the excess basis and the exchanged basis in Automobile Y.

Example 4. AB, a calendar-year taxpayer, purchased and placed in service Automobile X1 in February 2000 for \$10,000. X1 is a passenger automobile subject to section 280F(a) and is used solely for AB's business. AB depreciated X1 using a 5-year recovery period, the double declining balance method, and the half-year convention. As of January 1, 2003, the adjusted depreciable basis of X1 was \$2,880 (\$10,000 original cost minus \$2,000 depreciation deduction for 2000, minus \$3,200 depreciation deduction for 2001, and \$1,920 depreciation deduction for 2002). In November 2003, AB exchanges, in a like-kind exchange, Automobile X1 plus \$14,000 cash for new Automobile Y1 that will be used solely in AB's business. Automobile Y1 is 50-percent bonus depreciation property for purposes of section 168(k)(4) and qualifies for the expensing election under section 179. Pursuant to paragraph §1.168(k)-1(g)(3)(ii) and paragraph (k)(2)(i) of this section, AB decided to apply §1.168(i)-6 to the exchange of Automobile X1 for Automobile Y1, the replacement MACRS property. AB also makes the election under section 179 for the excess basis of Automobile Y1. AB depreciates Y1 using a five-year recovery period, the double declining balance method and the half-year convention. For 2003, the relinquished automobile section 280F limit for Automobile X1 is \$1,775 and the replacement automobile section 280F limit for 2003 for Automobile Y1 is \$10,710.

(i) The 2003 depreciation deduction for Automobile X1 is \$576. The depreciation deduction calculated for X1 is \$576 (the adjusted depreciable basis of Automobile X1 at the beginning of 2003 of $\$2,880 \times 40\% \times \frac{1}{2} \text{ year}$), which is less than the relinquished automobile section 280F limit and the replacement automobile section 280F limit.

(ii) The additional first year depreciation deduction for the exchanged basis is \$1,152. The additional first year depreciation deduction of \$1,152 (remaining

exchanged basis of \$2,304 (\$2,880 adjusted basis of Automobile X1 at the beginning of 2003 minus \$576) \times 0.5)) is less than the replacement automobile section 280F limit minus \$576.

(iii) AB's MACRS depreciation deduction allowable in 2003 for the remaining exchanged basis of \$1,152 is \$47 (the relinquished automobile section 280F limit of \$1,775 less the depreciation deduction of \$576 taken for Automobile X1 less the additional first year depreciation deduction of \$1,152 taken for the exchanged basis) which is less than the depreciation deduction calculated for the depreciable exchanged basis.

(iv) For 2003, AB takes a \$1,400 section 179 deduction for the excess basis of Automobile Y1. AB must reduce the excess basis of \$14,000 by the section 179 deduction of \$1,400 to determine the remaining excess basis of \$12,600.

(v) For 2003, AB is allowed a 50-percent additional first year depreciation deduction of \$6,300 (the remaining excess basis of \$12,600 multiplied by .50).

(vi) For 2003, AB's depreciation deduction for the depreciable excess basis is limited to \$1,235. The depreciation deduction computed without regard to the replacement automobile section 280F limit is \$1,260 (\$6,300 depreciable excess basis \times 0.4 \times 6/12). However the depreciation deduction for the depreciable excess basis is limited to \$1,235 (\$10,710 (replacement automobile section 280F limit) - \$576 (depreciation deduction for Automobile X1) - \$1,152 (additional first year depreciation deduction for the exchanged basis) - \$47 (depreciation deduction for exchanged basis) \$1,400 (section 179 deduction) - \$6,300 (additional first year depreciation deduction for remaining excess basis)).

(4) Involuntary conversion for which the replacement MACRS property is acquired and placed in service before disposition of relinquished MACRS property. If, in an involuntary conversion, a taxpayer acquires and places in service the replacement MACRS property before the date of disposition of the relinquished MACRS property, the taxpayer depreciates the unadjusted depreciable basis of the replacement MACRS property under section 168 beginning in the taxable year when the replacement MACRS property is placed in service by the taxpayer and by using the applicable depreciation method, recovery period, and convention prescribed under section 168 for the replacement MACRS property at the placed-in-service date. However, at the time of

disposition of the relinquished MACRS property, the taxpayer determines the exchanged basis and the excess basis of the replacement MACRS property and begins to depreciate the depreciable exchanged basis of the replacement MACRS property in accordance with paragraph (c) of this section. The depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (d)(4). Further, in the year of disposition of the relinquished MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation deductions that would have been allowable to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the relinquished MACRS property. However, see §1.168(k)-1(f)(5)(v) for replacement MACRS property that is qualified property or 50-percent bonus depreciation property and §1.1400L(b)-1(f)(5) for replacement MACRS property that is qualified New York Liberty Zone property.

(e) Use of optional depreciation tables--(1) Taxpayer not bound by prior use of table. If a taxpayer used an optional depreciation table for the relinquished MACRS property, the taxpayer is not required to use an optional table for the depreciable exchanged basis of the replacement MACRS property. Conversely, if a taxpayer did not use an optional depreciation table for the relinquished MACRS property, the taxpayer may use the appropriate table for the depreciable exchanged basis of the replacement MACRS property. If a taxpayer decides not to use the table for the

depreciable exchanged basis of the replacement MACRS property, the depreciation allowance for this property for the year of replacement and subsequent taxable years is determined under paragraph (c) of this section. If a taxpayer decides to use the optional depreciation tables, no depreciation deduction is allowable for MACRS property placed in service by the acquiring taxpayer and subsequently exchanged or involuntarily converted by such taxpayer in the same taxable year, and, if, during the same taxable year, MACRS property is placed in service by the acquiring taxpayer, exchanged or involuntarily converted by such taxpayer, and the replacement MACRS property is disposed of by such taxpayer, no depreciation deduction is allowable for either MACRS property.

(2) Determination of the depreciation deduction--(i) Relinquished MACRS property. In the year of disposition, the depreciation allowance for the relinquished MACRS property is computed by multiplying the unadjusted depreciable basis (less the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable) of the relinquished MACRS property by the annual depreciation rate (expressed as a decimal equivalent) specified in the appropriate table for the recovery year corresponding to the year of disposition. This product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of the exchange or involuntary conversion (taking into account the applicable convention) and the denominator of which is 12. However, if the year of disposition is less than 12 months, the depreciation allowance determined under this paragraph (e)(2)(i) must be adjusted for a short taxable year (for further guidance,

for example, see Rev. Proc. 89-15 (1989-1 CB 816) and §601.601(d)(2)(ii)(b) of this chapter).

(ii) Replacement MACRS property--(A) Determination of the appropriate optional depreciation table. If a taxpayer chooses to use the appropriate optional depreciation table for the depreciable exchanged basis, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined by choosing the optional depreciation table that corresponds to the recovery period, depreciation method, and convention of the replacement MACRS property determined under paragraph (c) of this section.

(B) Calculating the depreciation deduction for the replacement MACRS property.

(1) The depreciation deduction for the taxable year is computed by first determining the appropriate recovery year in the table identified under paragraph (e)(2)(ii)(A) of this section. The appropriate recovery year for the year of replacement is the same as the recovery year for the year of disposition, regardless of the taxable year in which the replacement property is acquired. For example, if the recovery year for the year of disposition would have been year 4 in the table that applied before the disposition of the relinquished MACRS property, then the recovery year for the year of replacement is Year 4 in the table identified under paragraph (e)(2)(ii)(A) of this section.

(2) Next, the annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula $(1 / (1 - x))$ where x equals the sum of the annual depreciation rates from the table identified under paragraph (e)(2)(ii)(A) of this section (expressed as a decimal equivalent) corresponding to the replacement MACRS property (as determined under

paragraph (e)(2)(ii)(A) of this section) for the taxable years beginning with the placed-in-service year of the relinquished MACRS property through the taxable year immediately prior to the year of disposition. The product of the annual depreciation rate and the transaction coefficient is multiplied by the depreciable exchanged basis (taking into account paragraph (e)(2)(i) of this section). In the year of replacement, this product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service by the acquiring taxpayer during the year of replacement (taking into account the applicable convention) and the denominator of which is 12. However, if the year of replacement is the year the relinquished MACRS property is placed in service by the acquiring taxpayer, the preceding sentence does not apply. In addition, if the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (e)(2)(ii) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 CB 816) and §601.601(d)(2)(ii)(b) of this chapter).

(iii) Unrecovered basis. If the replacement MACRS property would have unrecovered depreciable basis after the final recovery year (for example, due to a deferred exchange), the unrecovered basis is an allowable depreciation deduction in the taxable year that corresponds to the final recovery year unless the unrecovered basis is subject to a depreciation limitation such as section 280F.

(3) Excess basis. As provided in paragraph (d)(1) of this section, any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer at the time of replacement. Thus, if the taxpayer chooses to use the appropriate optional depreciation table for the depreciable excess

basis in the replacement MACRS property, the depreciation allowances for the depreciable excess basis are determined by multiplying the depreciable excess basis by the annual depreciation rate (expressed as a decimal equivalent) specified in the appropriate table for each taxable year. The appropriate table for the depreciable excess basis is based on the depreciation method, recovery period, and convention applicable to the depreciable excess basis under section 168 at the time of replacement. However, if the year of replacement is less than 12 months, the depreciation allowance determined under this paragraph (e)(3) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89-15 (1989-1 CB 816) and §601.601(d)(2)(ii)(b) of this chapter).

(4) Examples. The application of this paragraph (e) is illustrated by the following examples:

Example 1. J, a calendar-year taxpayer, acquired 5-year property for \$10,000 and placed it in service in January 2001. J uses the optional tables to depreciate the property. J uses the half-year convention and did not make any elections for the property. In December 2003, J exchanges the 5-year property for used 7-year property in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, J decided to apply §1.168(i)-6 to the exchange of the 5-year property for the 7-year property, the replacement MACRS property. The depreciable exchanged basis of the 7-year property equals the adjusted depreciable basis of the 5-year property at the time of disposition of the relinquished MACRS property, namely \$3,840 (\$10,000 less \$2,000 depreciation in 2001, \$3,200 depreciation in 2002, and \$960 depreciation in 2003). J must first determine the appropriate optional depreciation table pursuant to paragraph (c) of this section. Since the replacement MACRS property has a longer recovery period and the same depreciation method as the relinquished MACRS property, J uses the optional depreciation table corresponding to a 7-year recovery period, the 200% declining balance method, and the half-year convention (because the 5-year property was depreciated using a half-year convention). Had the replacement MACRS property been placed in service in the same taxable year as the placed-in-service year of the relinquished MACRS property, the depreciation allowance for the replacement MACRS property for the year of replacement would be determined using recovery year 3 of the optional table. The depreciation allowance equals the depreciable exchanged basis (\$3,840) multiplied by the annual depreciation rate for the current taxable year (.1749

for recovery year 3) as modified by the transaction coefficient $[1 / (1 - (.1429 + .2449))]$ which equals 1.6335. Thus, J multiplies \$3,840, its depreciable exchanged basis in the replacement MACRS property, by the product of .1749 and 1.6335, and then by one-half, to determine the depreciation allowance for 2003, \$549. For 2004, J multiplies its depreciable exchanged basis in the replacement MACRS property determined at the time of replacement of \$3,840 by the product of the modified annual depreciation rate for the current taxable year (.1249 for recovery year 4) and the transaction coefficient (1.6335) to determine its depreciation allowance of \$783.

Example 2. K, a calendar-year taxpayer, acquired used Asset V for \$100,000 and placed it in service in January 1999. K depreciated Asset V under the general depreciation system of section 168(a) by using a 5-year recovery period, the 200-percent declining balance method of depreciation, and the half-year convention. In December 2003, as part of the involuntary conversion, Asset V is involuntarily converted due to an earthquake. In October 2005, K purchases used Asset W with the insurance proceeds from the destruction of Asset V and places Asset W in service to replace Asset V. Pursuant to paragraph (k)(2)(i) of this section, K decided to apply §1.168(i)-6 to the involuntary conversion of Asset V with the replacement of Asset W, the replacement MACRS property. If Asset W had been placed in service when Asset V was placed in service, it would have been depreciated using a 7-year recovery period, the 200-percent declining balance method, and the half-year convention. K uses the optional depreciation tables to depreciate Asset V and Asset W. For 2003 (recovery year 5 on the optional table), the depreciation deduction for Asset V is \$5,760 $((0.1152)(\$100,000)(1/2))$. Thus, the adjusted depreciable basis of Asset V at the time of replacement is \$11,520 (\$100,000 less \$20,000 depreciation in 1999, \$32,000 depreciation in 2000, \$19,200 depreciation in 2001, \$11,520 depreciation in 2002, and \$5,760 depreciation in 2003). Under the table that applied to Asset V, the year of disposition was recovery year 5 and the depreciation deduction was determined under the straight line method. The table that applies for Asset W is the table that applies the straight line depreciation method, the half-year convention, and a 7-year recovery period. The appropriate recovery year under this table is recovery year 5. The depreciation deduction for Asset W for 2005 is \$1,646 $((\$11,520)(0.1429)(1/(1-0.5))(1/2))$. Thus, the depreciation deduction for Asset W in 2006 (recovery year 6) is \$3,290 $(\$11,520)(0.1428)(1/(1-0.5))$. The depreciation deduction for 2007 (recovery year 7) is \$3,292 $((\$11,520)(.1429)(1/(1-.5)))$. The depreciation deduction for 2008 (recovery year 8) is \$3292 (\$11,520 less allowable depreciation for Asset W for 2005 through 2007 $(\$1,646 + \$3,290 + \$3,292)$).

Example 3. L, a calendar-year taxpayer, placed in service used Computer X in January 2002 for \$5,000. L depreciated Computer X under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Computer X is destroyed in a fire in March 2004. For 2004, the depreciation deduction allowable for Computer X equals \$480 $([(\$5,000)(.1920)] \times (1/2))$. Thus, the adjusted depreciable basis of Computer X was \$1,920 when it was destroyed (\$5,000 unadjusted depreciable

basis less \$1,000 depreciation for 2002, \$1,600 depreciation for 2003, and \$480 depreciation for 2004). In April 2004, as part of the involuntary conversion, L acquired and placed in service used Computer Y with insurance proceeds received due to the loss of Computer X. Computer Y will be depreciated using the same depreciation method, recovery period, and convention as Computer X. L elected to use the optional depreciation tables to compute the depreciation allowance for Computer X and Computer Y. The depreciation deduction allowable for 2004 for Computer Y equals \$384 ($[\$1,920 \times (.1920)(1/(1-.52))] \times (1/2)$).

(f) Mid-quarter convention. For purposes of applying the 40-percent test under section 168(d) and the regulations under section 168(d), the following rules apply:

(1) Exchanged basis. If, in a taxable year, MACRS property is placed in service by the acquiring taxpayer (but not as a result of a like-kind exchange or involuntary conversion) and--

(i) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion and replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the relinquished MACRS property was placed in service by the acquiring taxpayer; or

(ii) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion, and in a subsequent taxable year is replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the replacement MACRS property was placed in service by the acquiring taxpayer; or

(iii) In a subsequent taxable year, disposed of by the acquiring taxpayer in a like-kind exchange or involuntary conversion, the exchanged basis of the replacement MACRS property is not taken into account in the year of replacement.

(2) Excess basis. Any excess basis is taken into account in the quarter the replacement MACRS property is placed in service by the acquiring taxpayer.

(3) Depreciable property acquired for nondepreciable property. Both the exchanged basis and excess basis of the replacement MACRS property described in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), are taken into account for determining whether the mid-quarter convention applies in the year of replacement.

(g) Section 179 election. In applying the section 179 election, only the excess basis, if any, in the replacement MACRS property is taken into account. If the replacement MACRS property is described in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), only the excess basis in the replacement MACRS property is taken into account.

(h) Additional first year depreciation deduction. See §1.168(k)-1(f)(5) (for qualified property or 50-percent bonus depreciation property) and §1.1400L(b)-1(f)(5) (for qualified New York Liberty Zone property).

(i) Elections--(1) Election not to apply this section. A taxpayer may elect not to apply this section for any MACRS property involved in a like-kind exchange or involuntary conversion. An election under this paragraph (i)(1) applies only to the taxpayer making the election and the election applies to both the relinquished MACRS property and the replacement MACRS property. If an election is made under this

paragraph (i)(1), the depreciation allowances for the replacement MACRS property beginning in the year of replacement and for the relinquished MACRS property in the year of disposition are not determined under this section (except as otherwise provided in this paragraph). Instead, for depreciation purposes only, the sum of the exchanged basis and excess basis, if any, in the replacement MACRS property is treated as property placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed of by the taxpayer at the time of disposition. While the relinquished MACRS property is treated as being disposed of at the time of disposition for depreciation purposes, the election not to apply this section does not affect the application of sections 1031 and 1033 (for example, if a taxpayer does not make the election under this paragraph (i)(1) and does not recognize gain or loss under section 1031, this result would not change if the taxpayer chose to make the election under this paragraph (i)(1)). In addition, the election not to apply this section does not affect the application of sections 1245 and 1250 to the relinquished MACRS property. Paragraphs (c)(5)(i) (determination of depreciation for relinquished MACRS property in the year of disposition), (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property to which this paragraph (i)(1) applies. See paragraph (j) of this section for the time and manner of making the election under this paragraph (i)(1).

(2) Election to treat certain replacement property as MACRS property. If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable

property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may elect to treat, for depreciation purposes only, the sum of the exchanged basis and excess basis, if any, of the replacement property as MACRS property that is placed in service by the taxpayer at the time of replacement. An election under this paragraph (i)(2) applies only to the taxpayer making the election and the election applies to both the relinquished property and the replacement property. If an election is made under this paragraph (i)(2), the adjusted depreciable basis of the relinquished property is treated as being disposed of by the taxpayer at the time of disposition. Rules similar to those provided in §§1.168(i)-6(b)(3) and (4) apply for purposes of determining the time of disposition and time of replacement under this paragraph (i)(2). While the relinquished property is treated as being disposed of at the time of disposition for depreciation purposes, the election under this paragraph (i)(2) does not affect the application of sections 1031 and 1033, and the application of sections 1245 and 1250 to the relinquished property. If an election is made under this paragraph (i)(2), rules similar to those provided in paragraphs (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property. Except as provided in paragraph (k)(3)(ii) of this section, a taxpayer makes the election under this paragraph (i)(2) by claiming the depreciation allowance as determined under MACRS for the replacement property on the taxpayer's timely filed (including extensions) original Federal tax return for the placed-in-service year of the replacement property as determined under this paragraph (i)(2).

(j) Time and manner of making election under paragraph (i)(1) of this section--(1)

In general. The election provided in paragraph (i)(1) of this section is made separately by each person acquiring replacement MACRS property. The election is made for each member of a consolidated group by the common parent of the group, by the partnership (and not by the partners separately) in the case of a partnership, or by the S corporation (and not by the shareholders separately) in the case of an S corporation. A separate election under paragraph (i)(1) of this section is required for each like-kind exchange or involuntary conversion. The election provided in paragraph (i)(1) of this section must be made within the time and manner provided in paragraph (j)(2) and (3) of this section and may not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting), except as provided in paragraph (k)(2) of this section.

(2) Time for making election. The election provided in paragraph (i)(1) of this section must be made by the due date (including extensions) of the taxpayer's Federal tax return for the year of replacement.

(3) Manner of making election. The election provided in paragraph (i)(1) of this section is made in the manner provided for on Form 4562, Depreciation and Amortization, and its instructions. If Form 4562 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

(4) Revocation. The election provided in paragraph (i)(1) of this section, once made, may be revoked only with the consent of the Commissioner of Internal Revenue. Such consent will be granted only in extraordinary circumstances. Requests for consent are requests for a letter ruling and must be filed with the Commissioner of Internal Revenue, Washington, DC, 20224. Requests for consent may not be made in

any other manner (for example, through a request under section 446(e) to change the taxpayer's method of accounting).

(k) Effective date--(1) In general. Except as provided in paragraph (k)(3) of this section, this section applies to a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004.

(2) Application to pre-effective date like-kind exchanges and involuntary conversions. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may--

(i) Apply the provisions of this section. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(i) by following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9 (2002-1 CB 327) and §601.601(d)(2)(ii)(b) of this chapter); or

(ii) Rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of replacement MACRS property and relinquished MACRS property (for further guidance, for example, see Notice 2000-4

(2001-1 CB 313) and §601.601(d)(2)(ii)(b) of this chapter). In relying on such guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(ii) by following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9 (2002-1 CB 327) and §601.601(d)(2)(ii)(b) of this chapter).

(3) Like-kind exchanges and involuntary conversions where the taxpayer made the election under section 168(f)(1) for the relinquished property--(i) In general. If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), paragraph (i)(2) of this section applies to such relinquished property and replacement property for which the time of disposition and the time of replacement (both as determined under paragraph (i)(2) of this section) both occur after February 26, 2007.

(ii) Application of paragraph (i)(2) of this section to pre-February 26, 2007, like-kind exchanges and involuntary conversions. If the tangible depreciable property

acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may apply paragraph (i)(2) of this section to the relinquished property and the replacement property for which the time of disposition, the time of replacement (both as determined under paragraph (i)(2) of this section), or both occur on or before February 26, 2007. If the taxpayer wants to apply paragraph (i)(2) of this section and the taxpayer's applicable Federal tax return has been filed on or before February 26, 2007, the taxpayer must change its method of accounting for depreciation of the replacement property and relinquished property in accordance with this paragraph (k)(3)(ii) by following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9 (2002-1 CB 327) and §601.601(d)(2)(ii)(b) of this chapter).

§1.168(i)-6T [Removed]

Par. 13. Section 1.168(i)-6T is removed.

Par. 14. Section 1.168(k)-1 is amended as follows:

1. The second and third sentences in paragraph (f)(5)(v)(B) are revised.
2. The last sentences in Example 1(i), Example 3(i), Example 4(i), and Example 5(i) in paragraph (f)(5)(vi) are revised.
3. Paragraph (g)(3)(ii) is revised.

The revisions read as follows:

§1.168(k)-1 Additional first year depreciation.

* * * * *

(f) * * *

(5) * * *

(v) * * *

(B) * * * However, at the time of disposition of the involuntarily converted MACRS property, the taxpayer determines the exchanged basis (as defined in §1.168(i)-6(b)(7)) and the excess basis (as defined in §1.168(i)-6(b)(8)) of the acquired MACRS property and begins to depreciate the depreciable exchanged basis (as defined in §1.168(i)-6(b)(9) of the acquired MACRS property in accordance with §1.168(i)-6(c). The depreciable excess basis (as defined in §1.168(i)-6(b)(10)) of the acquired MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (f)(5)(v)(B).

* * * * *

(vi) * * *

Example 1. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)-6(k)(2)(i), EE decided to apply §1.168(i)-6 to the involuntary conversion of Canopy V1 with the replacement of Canopy W1, the acquired MACRS property.

* * * * *

Example 3. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)-6(k)(2)(i), FF decided to apply §1.168(i)-6 to the exchange of Computer X2 for Computer Y2, the acquired MACRS property.

* * * * *

Example 4. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)-6(k)(2)(i), GG decided to apply §1.168(i)-6 to the exchange of Equipment X3 for Equipment Y3, the acquired MACRS property.

* * * * *

Example 5. (i) * * * Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)-6(k)(2)(i), GG decided to apply §1.168(i)-6 to the exchange of Equipment Y3 for Equipment Z1, the acquired MACRS property.

* * * * *

(g) * * *

(3) * * *

(ii) Paragraphs (f)(5)(ii)(F)(2) and (f)(5)(v) of this section apply to a like-kind exchange or an involuntary conversion of MACRS property and computer software for which the time of disposition and the time of replacement both occur after February 27, 2004. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, see §1.168(i)-6(k)(2)(ii). For a like-kind exchange or involuntary conversion of computer software for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of the acquired computer software and the exchanged or involuntarily converted computer software (for further guidance, see §1.168(k)-1T(f)(5) published in the **Federal Register** on September 8, 2003 (68 FR 53000)). In relying on such

guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement.

* * * * *

/s/ Kevin M. Brown

Deputy Commissioner for Services and Enforcement.

Approved: February 23, 2007

/s/ Eric Solomon

Assistant Secretary of the Treasury (Tax Policy).