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Bulletin #84, Tax−Free Exchanges of Tangible Personal Property (March 8, 2005)

How often do you buy and sell heavy equipment? Or replace a fleet of vehicles? Do you ordinarily have taxable capital gain or ordinary income recapture when you sell your used equipment?

These are some of the questions you should be asking before entering into contracts to sell your used equipment and buy replacements. There may be an opportunity for you to defer the recognition of taxable gain on the sale of used equipment if you structure the sale and purchase as part of a qualifying Section 1031 exchange.

Many perceive Section 1031 as a real property (a/k/a "land") tax−free exchange provision of the Internal Revenue Code. This narrow view ignores opportunities for tax−free exchanges of tangible personal property and may prove to be a costly oversight for some taxpayers. This *Contracts Bulletin* is intended to highlight the general rules and benefits of tax−free exchanges of tangible personal property.

Section 1031 Exchanges

Internal Revenue Code Section 1031(a)(1) provides that no gain or loss is recognized on the exchange of business property held for productive use ("relinquished property") if the relinquished 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 ("replacement property"). Section 1031 provides an opportunity to defer the payment of tax on capital gains recognized on the sale of property if the property is disposed of in a transaction that satisfies certain requirements.

The general requirements for Section 1031 include: (1) the relinquished property must be held for investment or use in a trade or business; (2) the relinquished property must be replaced with "like kind" property (a/k/a the same kind of property); (3) the replacement property must be identified within 45 days of sale of the relinquished property; (4) the exchange must be completed within 180 days of the sale of the relinquished property; and (5) during the exchange period, the taxpayer (a/k/a the contractor) must not actually or constructively receive the sale proceeds from the relinquished property.

Section 1031 can take the form of a simultaneous swap of property or an exchange deferred for 180 days. Most tangible personal property held for investment or used in a business qualifies for a Section 1031 exchange (this often includes vehicles and heavy equipment). As a result, if used personal property is sold only to be replaced by similar newer property within a short period of time, Section 1031 and the safe−harbor rules, promulgated by the IRS under Revenue Procedure 2003−39, provide an opportunity for taxpayers to roll over the gain from the property sold into the replacement property tax free.

Safe Harbor Rules for Personal Property Exchanges

In Revenue Procedure 2003−39, the IRS provided safe−harbor rules for companies that regularly buy and sell large quantities of tangible personal property. These guidelines clarify existing rules and provide a framework for establishing ongoing tax−free exchanges under a “like−kind exchange program” (“LKE Program”).

A “LKE Program” is an ongoing program involving multiple exchanges of 100 or more properties using a single qualified intermediary pursuant to a master exchange agreement. A qualified intermediary is a company that facilitates tax−free exchanges by coordinating the sale and purchase of the properties to be exchanged, managing the flow of funds and accounting for proceeds, and ensuring that the transactions are properly documented. Transfers of relinquished property and acquisitions of replacement property that do not satisfy the terms of the safe harbor rules provided in the revenue procedure may still qualify for tax−free exchange treatment under the general rules of Section 1031.

Requirement of a LKE Program

A LKE Program typically involves a deferred exchange. When a company enters into a contract to sell tangible personal property, such as heavy equipment or a fleet of trucks, with a view of replacing the property sold with newer property, it should perform a cost/benefit analysis to determine if engaging in a tax−free exchange would be worthwhile.

Ordinarily, the level of capital gain to be recognized and the benefits of a tax−free exchange have a direct relationship −− the greater the gain, the more significant the benefits of a tax−free exchange. When calculating the benefit of the exchange, however, the cost of doing the exchange, such as intermediary and legal fees, should be taken into account. Note that commissions and similar expenses paid to complete the exchange are added to the basis of the replacement property, which is depreciated overtime.

Here is a simple example to demonstrate the benefit of tax deferral through a tax−free exchange.

ZZZ Contractors, Inc. has $1,000,000 of heavy equipment depreciable over 10 years. Assume that ZZZ’s basis (that is, the “cost” recorded for the property for tax purposes) in the equipment is $300,000. The equipment manufacturer, DEF, has developed a new version of the equipment that ZZZ wants to purchase. The new version will cost ZZZ $1,200,000. If ZZZ were to sell its used equipment, it can realize up to $700,000. DEF does not accept trade−ins.

Scenario #1: ZZZ sells the equipment without Section 1031. ZZZ’s taxable gain is $400,000. Based on a combined federal and state effective tax rate of 40%, ZZZ would owe $160,000 in taxes on the sale of the equipment. ZZZ’s net cash flow after the tax is $540,000, so ZZZ must come up with an extra $660,000 to purchase the new equipment.

Scenario #2: ZZZ engages an intermediary and executes a Section 1031 exchange. ZZZ will defer the payment of the $160,000, which means that it needs to come up with only $500,000 (as compared to the $660,000 under Scenario #1), to purchase the new equipment. Thus, ZZZ gets to apply the $160,000 it would have paid in taxes toward its equipment purchase.

Some may argue that recognizing the gain and paying the tax provides a step−up in basis, which is recoverable through depreciation. True. ZZZ will have approximately $1,200,000 of basis under Scenario #1, compared to $800,000 under Scenario #2. Note, however, that the extra $400,000 of depreciation is spread over 10 years. Using a discount rate of 5% and an effective tax rate of 40%, the net tax benefit of the depreciation over 10 years is roughly $123,547.

Exchange Process

To treat the sale and purchase as part of the exchange, a company seeking to perform a 1031 exchange (the "Exchangor") must first enter into a series of exchange agreements with a qualified intermediary. These exchange agreements outline the terms of the exchange arrangement, such as the form of exchange, timeline, fees, escrow arrangements, liabilities, and other matters. Although exchange agreements are generally supplied by the intermediary and tend to be one−sided, there are certain provisions that can and should be negotiated.

One such provision deals with allocation of interest income between the Exchangor and the intermediary. When the Exchangor's property is sold on a deferred exchange, the money is deposited into an escrow account during the exchange period pending acquisition of the replacement property. Exchange agreements used by some intermediaries give the intermediary the right to retain the interest earned. Depending on the amount of money involved and how long it sits in escrow, the interest could be a significant sum of money. Consequently, the interest provision should be negotiated to transfer interest earned on escrowed amounts to the Exchangor at the end of the exchange period.

To allow the intermediary to participate in the closing, the Exchangor needs to execute assignment agreements assigning its rights in the underlying purchase agreements to the intermediary. Generally, a provision, such as the following, should be included in these agreements to indicate that the transactions are part of a tax−free exchange:

> The parties agree that Seller desires to transfer the Property by means of an exchange of "like−kind" property which will qualify as such under Section 1031 of the Internal Revenue Code of 1986, as amended, and regulations thereunder, at no increased cost or risk to Purchaser through the use of a third−party Intermediary as designated by the Seller. Purchaser is willing to cooperate to effectuate Seller's desire as aforesaid by participation in an appropriate exchange transaction. All other terms and conditions of the Agreement shall remain the same.

Once the exchange transactions are underway, the tangible personal property sold and purchased must be segregated into groups of like−kind property because tangible personal property is deemed to be of like kind to other tangible personal property, if it is within the same product or depreciation class. Therefore, an asset−by−asset analysis is needed to identify the groups to which each property belongs and the exchange is executed via a matching of the groups.

Each group of relinquished properties and each group of matched replacement properties is treated as a separate and distinct exchange transaction. As such, each exchange transaction must independently qualify as a tax−free exchange under Section 1031.

Conclusion

Companies that regularly buy and sell machinery, equipment, vehicles, and other types of tangible personal property with sizable residual value could benefit from tax−free exchanges. Because of the relatively short depreciable life of these types of assets, a disposition every few years could generate a tax on the sale, while also requiring additional cash outlay for the replacement property. A Section 1031 exchange would simply roll over the basis of the old property to the new, defer the gain, and free up cash for the business.

As with all advice in the *Contracts Bulletins*, we strongly encourage SMACNA members to discuss with their attorneys whether a 1031 exchange is right for their businesses.

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e−mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles, SMACNA's Executive Director – Market Sectors, (e−mail: tsoles@smacna.org; telephone: 703 803 2988).

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