



Like-Kind Exchanges in Equipment Replacement

BY BRIAN D. WORTH

Equipment: the lifeblood of many construction companies and the most significant asset on their balance sheets. Many contractors recognize significant taxable gains from the disposal of their equipment; but others, in an attempt to avoid such gains, are forced to trade in equipment, a decision that may or may not make sense economically.

The like-kind exchange rules of IRC §1031 may be used to prevent an unwanted taxable gain and allow the contractor the freedom to decide whether an outright sale or trade-in makes sense for the disposal of equipment. Although more commonly used with respect to the disposal of real estate, the like-kind exchange rules are equally applicable to disposals of personal property, including construction equipment.

This article discusses the rules related to the use of like-kind exchanges of equipment. It also provides examples of when an exchange may be appropriate and discusses the benefits to be derived from such an exchange.

General Rules of Like-Kind Exchanges

The rules for like-kind exchanges are included in the Tax Code and regulations under IRC §1031. They provide for the deferral of gain on the disposition of property held for productive use in a trade or business if exchanged solely for property of a like-kind to be used in a trade or business.¹

The provision cannot be used for property that is held for sale in the ordinary course of a trade or business. The basis of the property given up in the exchange carries over to the replacement property and is increased by the amount of *boot* (the amount of money or other property given up for the replacement property).

For the transaction to qualify, the taxpayer is not allowed to receive any cash in the transaction. Therefore, the taxpayer must invest at least as much in the new equipment as the value

of the equipment given up, and the amount of debt on the replacement equipment must not increase.

In its simplest form, the like-kind exchange is represented by the trade-in, where a contractor turns over an old piece of equipment to a dealer in partial payment on a new piece of equipment, and pays the difference in cash. Sometimes trade-ins are impractical or impossible to structure, for example in an outright sale of equipment. In these situations, a more sophisticated approach, known as the *deferred like-kind exchange*, can be used.

The majority of real estate transactions are currently structured this way, allowing for the freedom to sell the property for cash and replace it through a cash purchase of the replacement property. Prior to the introduction of the deferred like-kind exchange rules in 1992, deferring gain with a cash sale followed by a cash purchase would not have been permissible.

The Standard of Like-Kind in Personal Property

As noted above, the replacement property must qualify as like-kind for the exchange to qualify. Although this may seem straightforward, like-kind is a more difficult concept with respect to personal property than with real estate. Prior to the issuance of the final regulations for personal property exchanges, the standard for like-kind personal property was based on a *facts-and-circumstances* determination; the new regulations introduced the *like-class* safe harbor.²

Under the regulations, depreciable personal property is like-class if it is within the same General Asset Class or the same Product Class.³ Property within a General Asset Class consists of depreciable property described in Rev. Proc. 87-56. These types of depreciable tangible personal property are used in many businesses and are noted in Table 1.

Property within a Product Class consists of the depreciable, tangible, personal property that is listed under the four-digit

product class within Division D of the SIC manual, which contains the listings of manufactured products and equipment. Any Product Class ending with a "9" is a miscellaneous class and cannot be used as a safe harbor. Property listed in more than one Product Class is treated as listed in any one of the classes. A sample listing of equipment included in the Product Class for construction equipment (SIC Code 3531) is given in Table 2.

Exchanges must be within the same General Asset Class or Product Class to qualify as like-kind. Exchanges between classes are not allowed. Exchanges of property falling outside of the like-class safe harbor may still qualify as like-kind, but are not as clear-cut and, therefore, not recommended.

Example 1: A-1 Contractors has decided to acquire a dump truck. A-1 trades three older model pickup trucks and pays the dealer the remainder of the purchase price in cash. The exchange does not qualify as a like-kind exchange because the pickup trucks fall in General Asset Class 00.241 and the dump truck falls in General Asset Class 00.242. Exchanges between classes are not permitted, but a trade-in of an older model dump truck would have qualified.

Example 2: A-1 Excavation has decided to acquire a new motorized scraper. A-1 trades an older model dozer and an excavator and pays the dealer the remainder of the purchase price in cash. The exchange qualifies as a like-kind exchange because the scraper, dozer, and excavator are all included in the same Product Class, that of Construction Machinery and Equipment.

Deferred Like-Kind Exchanges

As previously noted, the preferred method of structuring real estate exchanges is also very useful for structuring equipment exchanges. The deferred like-kind exchange allows the sale of the property and the replacement of the property through a cash purchase.⁴

In its simplest form, the deferred like-kind exchange works as follows. The taxpayer engages the services of a qualified intermediary to facilitate the transaction. There are numerous technical requirements regarding who may serve as a qualified intermediary; many banks can fulfill this role, but the company's attorney or accountant may not.

The taxpayer transfers the rights to sell the old property to the qualified intermediary and the property is sold. The proceeds must be received and held by the qualified intermediary instead of the taxpayer. (Receipt of the proceeds by the taxpayer will result in a taxable gain.) Within 45 days, replacement property must be identified. The replacement property must be received within 180 days of the disposal of the original equipment. Purchase of the replacement equipment should generally not occur prior to the sale of the old, although these so-called *reverse exchanges* are now supported in tax authority if the requirements of Rev. Proc. 2000-37 are met.

Deferred transactions typically involve the legal costs of setting up the agreements and the cost of the qualified intermediary. An attorney who understands the complexities of like-kind exchanges and an experienced qualified intermediary should be used in the transaction. Because of the costs involved, these transactions are typically used only for the disposal of equipment in which significant gain is involved.

Benefits for the Contractor

The tax benefit of the like-kind exchange is that gain is deferred on the sale of the old equipment. This deferral takes place because the gain is not immediately recognized. The deferred gain amount reduces the basis of the replacement property and the basis of the replacement property is recovered through future depreciation deductions.

Because the basis of the replacement property is reduced, the depreciation recognized by the contractor is reduced from what would have been reported, absent the like-kind-exchange. This effectively spreads the gain recognition over the six-year recovery period used to depreciate construction equipment, which falls in the five-year class.

Example 3: A-1 Landscaping has decided to acquire a new skid loader. An old skid loader, with a tax basis of \$5,000 and a value of \$10,000, is traded in on a new one with a purchase price of \$20,000. A-1 also pays \$10,000 in cash. The gain on the trade-in (\$5,000) is not recognized because the exchange qualifies as like-kind. The basis of the new skid loader is \$15,000 (the \$5,000 basis of the old loader plus the additional \$10,000 paid).

The deferred gain of \$5,000 will effectively be recognized in the future because only \$15,000 of cost will be depreciated on the new loader instead of the full \$20,000. The trade-off is between gain recognition in the current taxable year vs. reduced depreciation deductions in the current and next five tax years.

Recognizing Situations Appropriate for a Like-Kind Exchange

When should a like-kind exchange be considered? In general, consider the like-kind exchange when: **1)** a piece of equipment is going to be disposed of at a gain, **2)** it is likely that the proceeds will be reinvested in like-kind property (new or used equipment), and **3)** the costs of implementing the exchange do not exceed the benefits of the exchange.

Finally, consider the need for the replacement property. Exchanges should never be entered into for the sole purpose of avoiding taxes when the acquisition of the replacement equipment does not meet the business objectives of the contractor. Following are several situations where the disposal of construction equipment can be expected to trigger a significant gain and exchanges should be considered.

Annual Sales of Equipment at Auction

Many contractors have an equipment replacement cycle and regularly dispose of equipment at auction. These may be ideal situations to use a deferred like-kind exchange. The contractor enters into an auction agreement with the auction house. The agreement is assigned to the qualified intermediary. The qualified intermediary accepts the proceeds from the sale and identification of replacement property is made. Prior to the expiration of the 180-day replacement period, new equipment is acquired by the qualified intermediary at the direction of the contractor.

S Corporation Elections - Avoiding Built-In Gains

In recent years, many contractors have elected to be treated as S Corporations. One significant problem associated with making this election can be the unrealized gain inherent in the contractor's equipment. If the contractor has equipment which is worth more than its tax basis, a disposition of that equipment in a taxable transaction within the first 10 years of being an S Corporation could result in a built-in gains tax. (The built-in gains tax is paid by both the corporation and its shareholders and, in effect, double-taxes the equipment gain.)

A deferred like-kind exchange transaction can avoid the built-in gains tax by postponing the recognition of gain on the sale of equipment beyond the 10-year taint period. Although the problem may also be alleviated by trading in equipment to avoid gain recognition, the deferred like-kind exchange offers more flexibility.

Sales of Businesses

Depending on the use of the proceeds, the deferred like-kind exchange can be built into the sale agreement to provide significant tax savings. This can be particularly effective in situations where contractors have multiple business divisions and have decided to sell off one of the divisions, but would like to reinvest the proceeds from the division's equipment into equipment for the other division. The sale contract would allocate a portion of the proceeds to the equipment sold and those funds would be paid to the qualified intermediary by the seller. As long as the replacement equipment meets the like-class standards discussed above, the gain from the sale of the equipment may be deferred.

Notice 2000-4

In January of 2000, the IRS released Notice 2000-4 which provides favorable guidance for taxpayers that acquire property through a like-kind exchange. These rules apply to replacement property placed in service after January 3, 2000.

As previously noted, the rules under IRC §1031 provide that the basis in the new property is equal to the carry-over basis in the old property, plus any additional boot paid by the taxpayer. In the past, when an asset was exchanged, many taxpayers would simply eliminate the replaced asset from their depreciation records, calculate the basis of the replacement asset, and

then enter the replacement asset, using the date it was placed in service and the depreciation life and method that were appropriate at that time.

The new rule provides that, to the extent the adjusted basis in the new property is the same as the old, the replacement property continues to be depreciated over the remaining recovery period of the exchanged property (using the depreciation method in place for the exchanged asset). In simple terms, the basis represented by the old asset continues to be depreciated using the same method and life. The additional basis, the boot, is set up as a new asset and is depreciated using the appropriate life and convention.

This provision is favorable to construction companies which use like-kind exchanges in the replacement of their equipment. For accountants who have to track fixed assets, it will generally require a change in the way replacement equipment is recorded in the fixed-asset records. A replacement asset may end up being carried on the books in several different pieces with different dates placed in service. It is important that these pieces be identified, either through asset numbers or descriptions, as being one asset.

The benefit of the new rules is that the remaining basis of the replaced property is recovered over the remaining tax life of that asset, instead of being depreciated as part of the new asset.

Example 4: A-1 Trenching acquired a new trenching machine in 1997. In May of 2000, A-1 decided to upgrade its machine and traded in the older model on a new one. Using the provisions of Notice 2000-4, the remaining basis in the original trencher would be recovered over the remaining tax depreciation period for that asset or the next three tax years. Under prior provisions, the remaining basis may have been rolled into the basis of the new machine and been recovered over the normal six tax years inherent in the five-year class.

For property placed in service before January 3, 2000, Notice 2000-4 permits a taxpayer to either continue to use its present method of depreciating the acquired property or to change its method to the method under this Notice. The change must be made in the first or second tax year ending after January 3, 2000, and taxpayers must follow all of the requirements of Rev. Proc. 99-49 for an automatic change in accounting method.

Because of the relatively short tax lives of construction equipment and the requirements that the accounting method adjustment be spread over time, most contractors will find it beneficial to continue their current methods on old assets.

Conclusion

In summary, the like-kind exchange rules can be very useful for contractors to avoid the tax problems of equipment replacement. In certain circumstances, the use of deferred like-kind exchanges can defer significant amounts of tax and allow contractors to make intelligent replacement decisions about their equipment. **BP**

Footnotes:

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1 In addition to property used in a trade or business, the like-kind exchange rules also apply to property held for investment. Such property is outside the scope of this article.

2 Regs. §1.1031(a)-1

3 Regs. §1.1031(a)-2(b)

4 The technical requirements of deferred like-kind exchanges are provided in Regs. §1.1031(k)-1.

TABLE 1

**General Asset Classes
under Revenue Procedure 87-56**

- Office furniture, fixtures, and equipment
(*asset class 00.11*)
- Information systems (computers & peripheral equipment)
(*asset class 00.12*)
- Data-handling equipment, except computers
(*asset class 00.13*)
- Airplanes (air frames and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (air frames and engines)
(*asset class 00.21*)
- Automobiles, taxis (*asset class 00.22*)
- Buses (*asset class 00.23*)
- Light general-purpose trucks (*asset class 00.241*)
- Heavy general-purpose trucks (*asset class 00.242*)
- Railroad cars and locomotives, except those owned by railroad transportation companies
(*asset class 00.25*)
- Tractor units for use over the road
(*asset class 00.26*)
- Trailers and trailer-mounted containers
(*asset class 00.27*)
- Vessels, barges, tugs, and similar water transportation equipment, except those used in marine construction
(*asset class 00.28*)
- Industrial steam and electric generation and/or distribution systems (*asset class 00.4*)

TABLE 2

**Sample Listing of Equipment
Product Class 3531 of the SIC Manual**

- Batching plants, for aggregate concrete and bulk cement
- Breakers, paving
- Bulldozers, construction
- Construction machinery, except mining
- Cranes, construction
- Ditchers, ladder: vertical boom or wheel
- Dozers, tractor mounted: material moving
- Dredging machinery
- Excavators (cable, clamshell, crane, derrick, dragline, power shovel)
- Mixers (concrete, ore, sand, slag, plaster, mortar, bituminous)
- Pavers
- Plows, construction: excavating and grading
- Pulverizers, stone: portable
- Scrapers, construction
- Soil compactors; vibratory
- Tampers, powered
- Tractors, construction
- Tractors, crawler
- Trenching machine
- Trucks, off-highway
- Work platforms, elevated

TAX & LEGISLATIVE AFFAIRS UPDATE

Comments Wanted on Proposed IRS Regs

The IRS has published proposed regulations (REG-105946-00) on the transfer of a contract accounted for under a long-term contract method of accounting to another taxpayer. Generally, the regs divide the rules on mid-contract change in taxpayer into two categories, constructive completion transactions and step-in-the-shoes transactions. Step-in-the-shoes rules will apply to:

- §381 and §351 transactions
- §368k(a)(1)(D) transactions that satisfy the requirements of §355 or §356
- Transfers of S Corporation stock
- Conversions to or from an S Corporation
- Members joining or leaving a consolidated group
- Any other transaction designated by the Service.

Constructive completion rules will apply to all other transactions.

Download the full text of the proposed regs, or register comments, at http://www.irs.gov/tax_regs/regslst.html and scroll down to "Mid-Contract Change in Taxpayer." Written and electronic comments on the regulations are due by May 17, 2001.

Good News for Contractors

According to a 2/9/01 Notice from the IRS Chief Council, several court decisions have recently upheld the use of the cash method of accounting by certain contractors. In these cases, the courts have rejected the Service's argument that the taxpayers were in the business of providing merchandise and, therefore, required to use inventory accounts and the accrual method of accounting. A link to the complete text of the Notice, including specific case citations and a clarification of the Service's interim position, can be found on the splash page of CFMA's Web site (www.cfma.org).

For updates on tax, legislative, and other matters of interest to construction financial managers, please refer to the Tax & Legislative Affairs page on CFMA's Web site:

www.cfma.org/public/new/tax_legislative.asp

Current postings include finalized IRC §460 regulations; FASB's revised stance on goodwill issues; the SEC update on auditor requirements; a heads-up on legislation heading to, or moving through, the Congress; and other timely information.

