

Like-Kind Exchanges 101 – Part 2

The process and program benefit

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This article is the second of a two-part series outlining the process and benefit of an LKE program. Part 1 is available under “Headlines” at www.naeda.com.

AT THE beginning of this new year, your business is probably going through the standard routine of financial projection, strategic thinking, and tax planning. This systematic review and forecasting process will set up your business for another successful year, which hopefully includes significant growth. But how is this development funded?

As you review your strategic tax initiatives, you will undoubtedly seek alternative methods to increase your cash flow. Properly instituted, full-service Like-Kind Exchange (LKE) programs complement your existing strategies and dramatically improve your cash position.

What is a Like-Kind Exchange?

Section 1031 of the Internal Revenue Code allows for companies to sell a depreciated asset and defer the taxable gain when the proceeds of the sale are used to purchase an asset of similar classification. Put simply, when you sell your capitalized assets, you can defer the tax (40 percent in most cases), if you use the proceeds from the sale to purchase like assets within a 180-day timeframe.

What is the benefit?

Consider the following case study: Koshnogos Equipment (a taxpaying company) is in the business of selling and renting equipment. Given the high usage rates associated with its rental equipment, the dealership typically sells its used assets every three years and upgrades to the newest versions available. One common transaction for Koshnogos is the sale and repurchase of a tractor for inclusion in its rental fleet.

FIGURE 1: Pre-LKE Program Sale

Original Equipment Cost	\$130,000
Tax Depreciation Allowed	\$103,792
Tax Basis at Time of Sale	\$26,208
Sale Price of Equipment (50%)	\$65,000
Taxable Gain on Sale	\$38,792
Tax on Gain (40% Tax Rate)	\$15,517
Cash Available for Replacement	\$49,483

NOTE: In this example, we are assuming five-year Modified Accelerated Cost Recovery System (MACRS) depreciation on an asset held for three years with bonus depreciation applied during the first year.

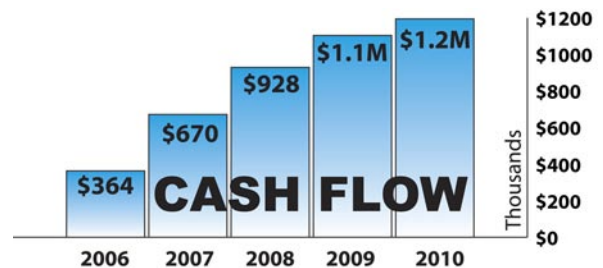
Prior to establishing an LKE program, the tax on the original tractor would be \$15,517, leaving only \$49,483 available for purchasing a replacement machine. When the replacement tractor is sold in three years, it would generate additional tax liability. With an approved

LKE program, however, Koshnogos Equipment would maintain all proceeds from the original sale to roll forward into its replacement asset (as shown in figure 2).

FIGURE 2: Post-LKE Program Sale

Original Equipment Cost	\$130,000
Tax Depreciation Allowed	\$103,792
Tax Basis at Time of Sale	\$26,208
Sale Price of Equipment (50%)	\$65,000
Taxable Gain on Sale	\$38,792
Tax on Gain (40% Tax Rate)	\$0
Cash Available for Replacement	\$65,000

In establishing a repetitive LKE program, Koshnogos Equipment could continue to roll this tax deferral indefinitely if the business remains in the business of selling, leasing and renting the same type of equipment. If we were to assume that Koshnogos Equipment expects to sell \$2 million of equipment this year and grow the business by 2 percent each year going forward, the cumulative cash flow impact to the business looks like the following:



As you review your tax strategies, you will find LKE programs offer an indefinite source of cash for your business to become more flexible in an increasingly competitive market. ■

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More information about LKE programs is available from:

- Accruit, LLC
www.accruit.com
877/793-9215
- Review Internal Revenue Service documentation
www.irs.gov
- Consult your tax advisor