

Safe Like-Kind Exchanges

Occasionally, people push the envelope and create a potential problem.

Many rental companies, dealers and contractors are taking advantage of like-kind exchange (LKE) transactions to defer taxable gains on qualified sales of used equipment, and if you meet the LKE requirements, there is little reason not to use the tool if you have current taxable income to offset or are likely to have taxable income in the near future.

While LKE may sound easy, it can be very complicated. There is, however, flexibility in the process that gives taxpayers the ability to use an LKE or decide to have the taxable gain reflected in their taxable income.

With an LKE, an equipment owner can sell a business asset at a gain and defer the gain (calculated using tax depreciation) to a future date as long as they use the sales proceeds to purchase a qualified replacement unit.

The amount of the gain deferred has to reduce the tax basis in the new replacement property and as a result, the depreciation deduction going forward is now lower than it would have been had LKE not been used.

For example, if you sell a machine for \$50,000 with zero tax basis (fully depreciated) and purchase a new machine for \$200,000, with LKE the \$50,000 gain is deferred, you have a \$20,000 LKE benefit and the tax basis in the new unit is \$150,000. Depreciation going forward without LKE is \$40,000 the first year vs. \$30,000 if you use LKE.

Another LKE requirement is that sales proceeds be restricted until they are used to purchase the new unit or pay down equipment related debt.

In addition, the funds should be held by a “qualified intermediary” until they are used to repurchase replacement property, pay down equipment related debt or removed from the account as a taxable distribution. As you can see, this can get complicated and with more equipment owners using LKE to manage their tax positions and cash flow, it’s imperative that you are certain of your tax position.

Occasionally, people push the envelope and create a potential problem. We are starting to see pass-through transactions in which machines are provided to a dealer who sends them to auction and receives the sales proceeds to offset the cost of the new unit with the customer believing the transaction is an LKE. At the same time, the dealer is taking the transaction and treating the used unit as a “trade-in” thus charging a lower sales tax (where applicable).

In this example, is this pass-through transaction as described an LKE? Can the auction proceeds be treated as a trade-in for sales tax purposes? The answers are maybe and probably depending on how the transactions are structured and documented.

Reviewing this transaction, you find no third party intermediary used to hold the restricted funds. In addition, the “sold” unit was actually sold and proceeds were collected, thus potentially negating the trade-in for tax purposes.

One way this transaction can be an LKE is by



LKE funds are held by a “qualified intermediary” until they are used to repurchase replacement property or pay down equipment-related debt, or are removed from the account as a taxable distribution.

doing a simultaneous transaction, transferring the original unit and taking possession of a replacement unit the same day. If you do this, LKE is available without the use of the third party intermediary.

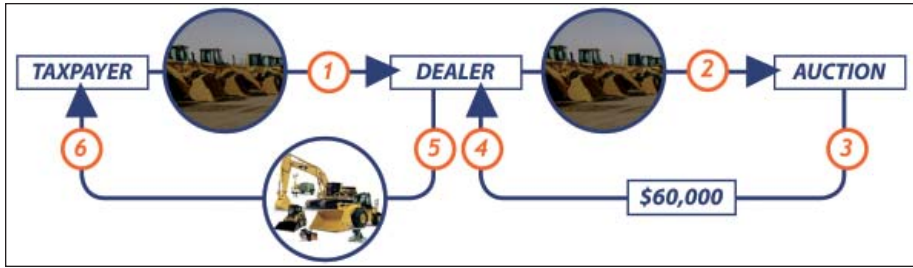
Sales tax law differs from state to state. It would be smart to get some expert advice before trying to make this type of transaction a trade-in transaction and to help you understand who gets the tax liability should there be one.

To back up my conclusions about this type of transaction, I asked two of the leading LKE service providers if they believe the transaction as described above would provide LKE benefits other than as a simultaneous transaction. I got two different answers.

Jeff Nelson of PWC says, “The transaction described is fairly common in the industry, and customers and dealers should be able to structure these types of contingent/consignment value contracts in compliance with the rules of IRC Sec 1031 even without the services of a Qualified Intermediary.



WRITTEN BY
GARRY BARDECKI



However, an LKE is extremely dependent on the proper form of the transaction. There are no short cuts and customers and dealers must be careful to respect that form when structuring their trade-ins.” (Jeff Nelson of PWC can be reached at 612-889-5973 or jeff.nelson@us.pwc.com.)

Jim Burnett of Accruit LLC says “Pass-throughs without a Qualified Intermediary involved may fall outside of the safe harbor guidelines as established in IRC 1031. The fact that there is typically a delay between the time the original asset is transferred to a dealer, and the date replacement property is acquired raises questions.

LKEs are not optional.

“Guidance suggests that 1031 exchanges are form over substance, meaning that if it looks like an exchange, the taxpayer must follow a specific process, including execution of an exchange agreement, notification of assignment in writing, inclusion of a Qualified Intermediary (to avoid constructive receipt), and completion of Form 8824 as part of the taxpayer’s tax filing. Additionally, given the tremendous benefit and low cost of single exchanges, even the smallest equipment transaction can be run as a safe harbor LKE.” (Accruit offers a document that discusses this issue in more detail. Call

If you do a simultaneous transaction, transferring the original unit and taking possession of a replacement unit the same day, LKE is available without the use of the third party intermediary.

720-963-5000 for a copy.)

As you can see LKE’s are complicated, and even the experts have a hard time agreeing on certain issues.

LKE’s can provide a significant benefit for rental companies, dealers and contractors if used properly. Please make an effort to understand the basic LKE qualification concepts and be wary of any transaction in which a Qualified Intermediary is not part of the process. The sales tax issues should also be reviewed with your tax advisor.

This article is not intended to be tax advice. Readers should contact their tax accountants for professional tax services.

Garry Bartecki (gbartecki@aednet.org) is director of distributor services in the Chicago office of BDO Seidman, an international consulting and accounting firm.