Tax Deferred Exchanges

This gift from the IRS can help equipment lessors make their operations more profitable.

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It happens all the time. A call comes in from a knowledgeable accountant: "We have a client who is replacing equipment and wants to defer paying taxes. We need some help with an IRC section 1031 exchange." What's being referred to here is a tax deferred exchange, which essentially gives taxpayers the right to transfer value from one business or investment property to another one of "like kind" without paying taxes on any gain in the process.

As the Internal Revenue Code puts it in section 1031(a)(1): "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

The government's rationale behind tax deferred exchanges is that the exchange of one piece of property for another of equal or greater value is essentially a continuous investment and, therefore, shouldn't be taxed.

Exchanging Old for New

So what does all of this have to do with equipment? Equipment is a form of property that qualifies for an exchange. To understand why the owner of equipment should consider exchange transactions, let's take a look at the following situation.

Equipment is returned at the end of the lease because customers are interested in updating their equipment. Equipment lessors continually sell the old equipment and buy new equipment to replace it. To make the point, look at the following simplified numbers pertaining to a single piece of equipment.

Original Value of Old Equipment	$300,000
Depreciation Taken During Lease	$250,000
Tax Basis	$50,000
Current Market Value	$150,000
Less the Tax Basis	-$50,000
Recapture of Depreciation	$100,000
Tax Rate	x 31%
Tax Due	$31,000
Cash from Sale	$150,000
Tax	$31,000
Cash Available for New Equipment	$119,000

In most cases, having $31,000 less to invest in new equipment is not the best alternative for this company. The best alternative is to structure the same transaction as an exchange of like-kind property used in business. When done correctly, the $31,000 goes into new property instead of going to the IRS.

Does the equipment leasing company avoid the tax completely? In most situations the tax is deferred, not avoided. This deferral can be continuous in the sense that the new equipment can be exchanged again at the end of the new lease, continuing the deferral of taxes. It is rare that successful business owners will not seize every opportunity to extend the use of cash that is available to them. So even if lessors only defer the tax liability, they still have the use of their most valuable business commodity—cash.

But at what level does a tax deferred exchange make sense? Lessors find that exchanges can be worthwhile for equipment that has a residual market value of as little as $5,000 to $10,000, depending on the volume of the equipment being exchanged. Various kinds of equipment can be

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subject to consideration of tax deferral, including the following:

- Manufacturing Equipment
- Packaging Equipment
- Aircraft
- Restaurant Assets
- Rail Cars
- Construction Equipment
- Printing Equipment
- Computer Equipment
- Automobiles
- Trucks

The list is nearly endless; most types of property should be considered for tax deferred exchanges.

Mechanics of a Tax Deferred Exchange

How does a tax deferred exchange work? The original concept called for a swap of like-kind property between two owners at the same time. The regulations have since developed to the point where lessors can now negotiate the sale of equipment to one party and arrange the acquisition of new equipment from a completely unrelated third party. Furthermore, it doesn't even have to be simultaneous. Lessors now have 45 days to identify new equipment and 180 days from the date of transfer of the old equipment to complete the exchange.

In simple terms, lessors are taxpayers who negotiate the terms of the related sale of old equipment and acquisition of new equipment. Their "qualified intermediary" facilitates transactions and helps qualify them as an exchange under the technical provisions of the regulations. In fact, the current regulations make it imperative that lessors select an experienced intermediary.

In IRC Section 1031 regulations, the "qualified intermediary" and "qualified escrow" safe harbors are the recommended means of structuring deferred exchanges that when properly completed, will not be challenged by the IRS as to form. It is possible to structure exchanges in other ways without using these safe harbors, but in doing so, the buyer of the relinquished property must remain an active participant in the acquisition of replacement property.

With the use of a qualified intermediary, the transaction is facilitated by the intermediary standing in place of the buyer and consummating an exchange with the taxpayer. In addition, using a qualified escrow provides a secure and permitted source of holding the funds during the exchange period. The funds are effectively removed from the buyer's possession or control while protecting against the taxpayer's actual or constructive receipt. Under provisions of a third safe harbor, interest on the exchange deposit is payable to the taxpayer upon conclusion of the exchange.

Under the regulations, in order for an intermediary to consummate an exchange with a taxpayer, one of three events must take place: the intermediary must come into title to the relinquished and replacement properties; or the intermediary must enter into contracts for the acquisition and transfer of the relinquished and replacement properties; or the intermediary must take an assignment for existing contracts providing for the acquisition and transfer of those properties.

In practice, it is usually easiest to take an assignment of the contracts. In that case, it is critical for the taxpayer to provide written notice to all parties, including co-sellers or co-buyers, that the assignment is taking place. Notwithstanding the assignment of certain rights and obligations of the taxpayer to the intermediary, the regulations allow direct transfer of property between the taxpayer and the relinquished property buyer and the replacement property seller.

The regulations allow 45 days from the date of transfer of the relinquished property in which to identify replacement property. The identification must be in writing and signed by the taxpayer. If all replacement property will actually be received within the 45 day period, then no written identification is needed.

Taxpayers can identify up to three properties for each relinquished property transferred, without regard to market value. If they intend to purhase or identify more than three properties, then they must consider additional rules, known as the 200 percent rule and the 95 percent rule. The taxpayer has 180 days from the date of transfer, or less based on the due date for filing taxes, in which to actually acquire one or more of the replacement properties identified.

By the conclusion of the transaction, the intermediary's file should contain an original exchange agreement, an assignment of contract

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relating to the relinquished and replacement properties, copies of those contracts, and a notice of identification of replacement property.

A Boon to Lessors

More than ever, tax deferred exchanges are a valuable tool for leasing companies that sell old equipment for more than the taxable basis of that property. Tax deferral through an exchange includes the following benefits:

- Taxes payable this year are decreased.
- Cash flow is increased.
- All value is transferred from the old property to the new.
- Time value on a lessor's cash is improved.
- Borrowing needs are decreased.

Structuring tax deferred exchanges is made easier by relying on the expertise and reliability of an experienced intermediary. Qualified intermediaries have developed the basic documents to make structuring an exchange more of a turnkey process, leaving a minimum amount of work for lessors and their advisors to take advantage of exchanging like-kind equipment. Working with a lessor's tax and legal advisors, an intermediary can help leasing companies take advantage of this important tax deferral opportunity and, ultimately, help make operation more profitable.

Reprinted from *Equipment Leasing Today,* February, 1996. Edited slightly for clarity.