Tax Deferred Exchanges:

A Vehicle Lessor Strategy For Maximized Operating Efficiency

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You have done everything possible to minimize your operating costs. In fact, they have been managed down to a razor's edge from purchasing, to maintenance of your fleet, to fuel costs and, ultimately, to how vehicles are sold. Is there anything more that can be done? If you own your vehicles, depreciate them for tax purposes, and sell them rather than trade them in, there is another advantage for you to gain — income tax deferral via "tax-deferred exchanges" rather than the existing practice of selling older vehicles and purchasing new ones.

Definition

What exactly is a tax-deferred exchange? It is the right to transfer value from one business asset or property to another one of "like-kind" without paying taxes on any gain in the process. As the Internal Revenue Code puts it — IRC 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 business use property for another of equal or greater value is essentially a continuous investment and, therefore, shouldn't be taxed.

Historical Perspective

Historically, there have been several notable events that have shaped today's tax-deferred exchange. 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 you can now negotiate the sale of vehicles to one party, and acquire new vehicles from a completely unrelated third party.

Section 1031 did not have a lot of applicability until the 1980s when a landmark legal decision made trade opportunities much more practical. Prior to the decision in the *Starker* case, Section 1031 was generally interpreted as requiring an exchange of assets to take place on a simultaneous basis. The taxpayer in the *Starker* case, however, successfully litigated the concept that the specific provisions of Section 1031 did not require the disposition of an asset in exchange for the acquisition of a replacement asset to be simultaneous. In fact, this case actually involved a five year period between the transfer of the first property in exchange for the replacement property. In 1984, Section 1031 was legislatively expanded to place reasonable limits on the time frame between the sale and subsequent purchase of one asset for another, while still being considered a trade. Since 1984, a taxpayer has 45 days from the date of sale (transfer) to identify its replacement assets and 180 days to actually acquire those assets.

Since the mid-1980s, exchanges have been more attractive to many businesses and individuals since a non-simultaneous acquisition was much easier to structure. However, several additional impediments still made them somewhat difficult to effectuate. The first impediment had to do with the need for the asset buyer to remain in a position to trade a replacement like-kind asset back to the taxpayer. For an exchange to work properly, the taxpayer would sell an asset or assets (although the taxpayer would not be treating it as a sale, but as an exchange for its tax purposes), and within a six-month period would direct the buyer to acquire like-kind assets from a third-party seller to be traded back from the buyer to the taxpayer to conclude the swap.

It often proved difficult to induce buyers to acquire the new asset or assets because they did not want to bother being involved in a more complicated transaction designed to enable the seller to defer taxes. It was difficult to obtain the buyer's necessary level of cooperation and participation.

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Additionally, during the period of up to six months, the taxpayer could not hold the buyer's funds or would be deemed to have completed a sale to the buyer rather than a trade. On the other hand, allowing the funds to remain with the buyer after the asset transfer to the buyer was clearly not prudent.

Current Practice

In 1991, the Internal Revenue Service published detailed regulations which, among other things, resolved these difficulties in properly structuring tax-deferred exchanges. These new regulations, together with the legislative changes in the wake of the *Starker* decision, gave rise to the rapid increase in popularity of tax-deferred exchanges nationwide. The 1991 regulations suggest that taxpayers may wish to avail themselves of several "safe harbors" in structuring a tax-deferred exchange. One safe harbor involves retaining the services of a "qualified intermediary" to act as a middleman standing in the place of the buyer to help document an exchange on the part of the taxpayer. The other safe harbor involves retaining the services of a "qualified escrowee or trustee" for purposes of holding the buyer's funds until they are used toward the acquisition of replacement assets.

Many attorneys, accountants and business owners are familiar with tax-deferred exchanges as a means of avoiding capital gain tax upon the disposition of highly appreciated real estate. With rising popularity, exchanges of personal property, such as equipment, machinery, individual vehicles, or multiple vehicles as part of vehicle leasing operations, are equally viable. But because their benefits are not as immediately apparent, this type of tax-deferred exchange has been underutilized. As stated above, in the case of such personal property, due to accelerated depreciation, the basis in that property is typically lower than the market value at the time of disposition.

As a result, upon sale, the difference between the basis and the sale price is going to be subject to recapture tax. Deferring this recapture tax can be as valuable to a business as deferring a capital gain.

Automobile Leasing and Fleet Owner Application

So how does the concept apply to cars and trucks? Because vehicles are a form of property that qualify for an exchange, let's look at the following example to obtain a better understanding of why owners of vehicle leasing operations should consider tax-deferred exchange transactions:

Cars and trucks are being returned at the end of a lease because the customers are interested in driving new vehicles. You will continually be selling the old cars or trucks and regularly buying new vehicles to replace them. Let's look at some overly simplified numbers, pertaining to a month where 100 vehicles are replaced, to make our point:

Original Value of Old Equipment	$2,500,000
Depreciation Taken During the Lease	$2,000,000
Tax Basis	$500,000
Current Market Value	$1,125,000
Less the Tax Basis	$500,000
Recapture of Depreciation	$625,000
Tax Rate	x 31%
Tax Due	$193,750
Cash From Sale	$1,125,000
Tax	$193,750
Cash Available for New Equipment	$931,250

In most cases, having $193,750 less to invest, per month, in new vehicles is not the best alternative for this company. The best alternative is to structure the same transaction as a tax-deferred exchange of like-kind property used in a business. When done correctly, the $193,750 is used to purchase new cars and trucks rather than going to a non-essential part of a vehicle leasing operation's business — taxes.

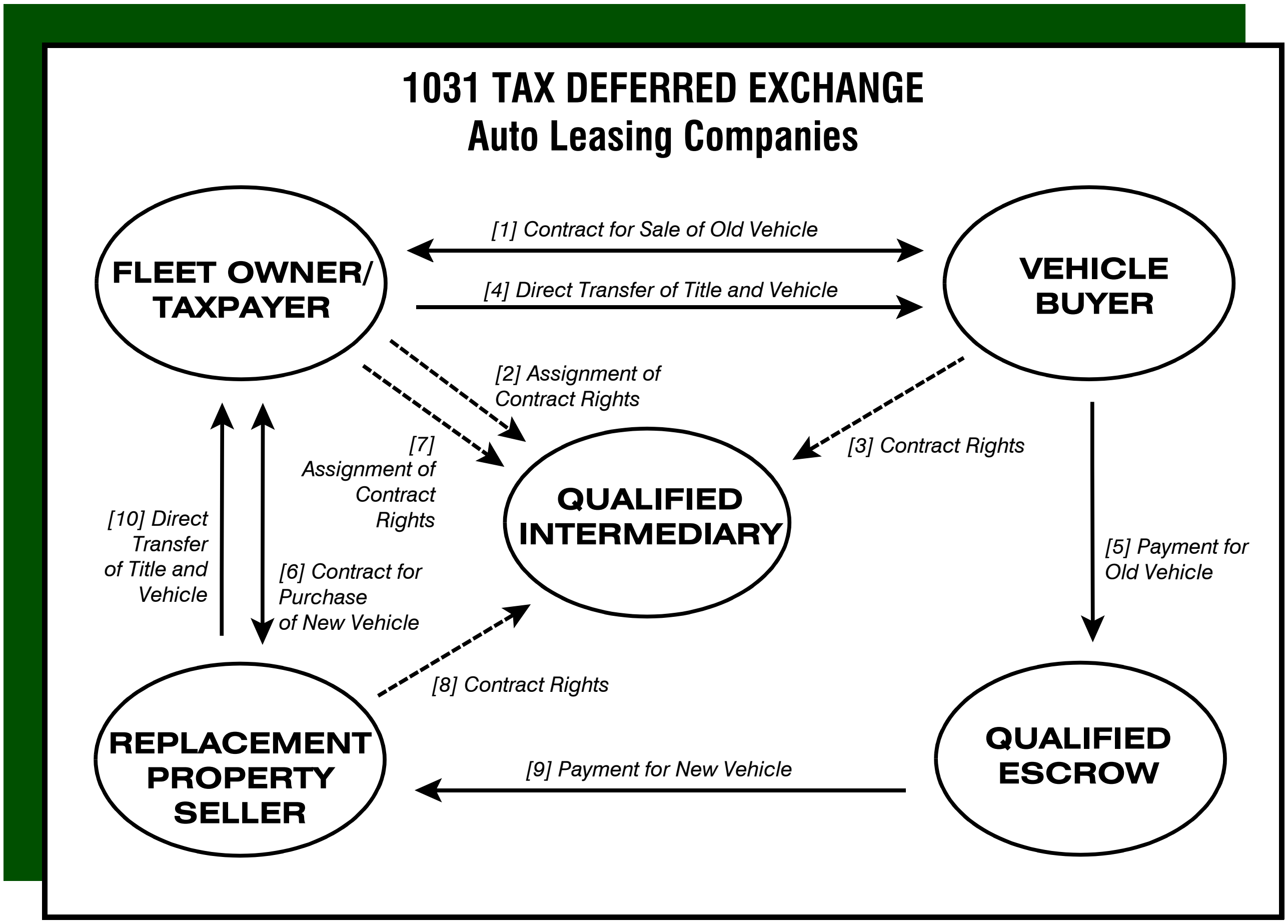
Do you avoid the tax completely? In most situations the tax is deferred, not avoided. This deferral can be continuous in the sense that the new equipment can be exchanged repeatedly at the end of each new lease, continuing the deferral of taxes indefinitely. It is rare that successful business owners and managers will not capitalize on every opportunity to extend the use of cash that is available to them. So even if you only defer the tax liability, you still have continual use of your most valuable business commodity — CASH.

At what level does a tax-deferred exchange make sense? You will find that tax-deferred exchanges can be worthwhile for vehicles that have a residual market value that is $1,000 greater than the tax basis in that car or truck. This is possible because of some of the efficiencies that can be gained by selecting the right intermediary. That brings us to a discussion of how all this works.

Mechanics of an Exchange

The illustration shows the steps involved in completing the exchange. You play the part of the taxpayer who negotiates the terms of the related sale of old cars or trucks and acquisition of new one. Your "qualified intermediary" is there to facilitate the transaction and help qualify the transaction as an exchange under the technical provisions of the regulations. In fact, the current regulations make it imperative that you select an experienced intermediary.

The good news is that some experienced "qualified intermediaries" have developed the basic documents to make structuring a tax-deferred exchange more of a turnkey process. Some intermediaries go even further by condensing some of the required steps when the volume of property being exchanged is large and continuous. What this means is that there is a minimum amount of work for you and your advisors to do to take advantage of the benefits of exchanging like-kind assets such as cars or trucks.


1031 TAX DEFERRED EXCHANGE
Auto Leasing Companies
FLEET OWNER/ TAXPAYER
VEHICLE BUYER
QUALIFIED INTERMEDIARY
REPLACEMENT PROPERTY SELLER
QUALIFIED ESCROW
[1] Contract for Sale of Old Vehicle
[2] Assignment of Contract Rights
[3] Contract Rights
[4] Direct Transfer of Title and Vehicle
[5] Payment for Old Vehicle
[6] Contract for Purchase of New Vehicle
[7] Assignment of Contract Rights
[8] Contract Rights
[9] Payment for New Vehicle
[10] Direct Transfer of Title and Vehicle

Summary

Tax-deferred exchanges are a valuable tool to vehicle leasing companies that sell old vehicles 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 of the market value is transferred from old vehicles to new
- Time value on your cash is improved; borrowing needs are decreased

Structuring tax-deferred exchanges is made easier by relying on the experience and reliability of an experienced qualified intermediary. Your intermediary working with your tax and legal advisors will help you take advantage of this important tax deferral opportunity and help make your leasing or fleet operation more profitable. ■

Reprinted from *Vehicle Leasing Today*,
March/April, 1997. Edited slightly for clarity.