

TAX MATTERS

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PERSONAL PROPERTY EXCHANGES

By Michael J. Yesk

*Vice President and Regional Manager
Investment Property Exchange Services, Inc.*

The tax deferred exchange, as defined in Section 1031 of the Internal Revenue Code of 1986, as amended, offers businesses one of the last great opportunities to build wealth and save taxes. By completing an exchange, a business ("Exchanger") can dispose of its personal property, use all of the equity to acquire replacement personal property, defer the capital gain tax that would ordinarily be paid, and leverage all of their equity into the replacement property. Two requirements must be met to defer the capital gain tax: (a) the Exchanger must acquire "like-kind" or "like-class" replacement property of equal or greater value, and (b) the Exchanger cannot receive cash or other benefits (unless the Exchanger pays capital gain taxes on this money).

In any exchange the Exchanger must enter into the exchange transaction prior to the close of the sale of the relinquished property. The Exchanger and the Qualified Intermediary enter into an Exchange Agreement, which essentially requires that (a) the Qualified Intermediary acquire the relinquished property from the Exchanger and transfer it to the buyer by the appropriate title document or bill of sale from the Exchanger and (b) the Qualified Intermediary acquire the replacement property from the seller and transfer it to the Exchanger by the appropriate title document or bill of sale from the seller. The cash or other proceeds from the relinquished property are assigned to the Qualified Intermediary and are held by the Qualified Intermediary in a separate, secure account. The exchange funds are used by the Qualified Intermediary to purchase the replacement property for the Exchanger.

Exchanges must be completed within strict time limits. The Exchanger has 45 days from the date the relinquished property closes to "Identify" potential replacement properties. This involves a written notification to the Qualified Intermediary listing an unambiguous description of the potential replacement properties. The purchase of the replacement property must be completed within 180 days after of the close of the relinquished property. After the 45 days has passed, the Exchanger may not change their Property Identification list and must purchase one of the listed replacement properties or the exchange fails.

"Personal property" refers to all property, both tangible and intangible, that is not considered real property. If the sale of such personal property will result in a gain, the taxpayer may want to consider an exchange. Generally speaking, both tangible depreciable personal property, such as cars, trucks and planes and intangible personal property, such as franchise rights, copyrights or broadcast spectrums, are acquired for a certain value known as a tax or cost basis.

For example, if a truck is purchased for \$10,000 cash and \$30,000 in a loan, the tax basis for the truck is \$40,000. The tax basis can be depreciated over time at different rates depending on the type of property and when it was acquired. For example, an automobile is currently considered a five year property under the Modified Accelerated Cost Recovery System (MACRS) of IRC §168, meaning that five years after its acquisition its tax basis will be zero.

Depreciation is subtracted from the asset's tax basis and any non-expensed items improving the personal property are added to its tax basis, resulting in its adjusted basis. For example, an airplane is acquired for \$120,000, which is its tax basis. Over a period of time it is depreciated in the amount of \$36,000 to account for normal wear and tear, but it has had a capital improvement in the form of an avionics upgrade in the amount of \$20,000. Therefore, the tax basis of \$120,000, minus the depreciation of \$36,000, plus the capital improvement of \$20,000 results in an adjusted basis of \$104,000.

In order to calculate if there is a capital gain tax liability from the sale of an asset, subtract the adjusted basis from the net sale price of the property. If the resulting amount is positive, there is a gain, and in most cases, a determination must be made as to what portion of the gain is due to the depreciation of the asset, and what portion of the gain is due to the appreciation (rise in market value) of the asset, as they may be taxed at different rates.

For example an automobile is purchased for use by a business for \$38,000, and is sold for \$24,000 after three years. Although its cost basis was \$38,000, it has been depreciated in the amount of \$28,500, leaving an adjusted basis of \$9,500. Accordingly, since the automobile is selling for \$14,500 more than its adjusted basis, there is a tax liability. Assuming a 35% tax rate for depreciation recapture, (depreciation recapture for personal property is taxed as ordinary income) the taxpayer in this example would owe approximately \$5,075. For leasing companies and companies with large privately held fleets that dispose of and acquire thousands of vehicles per year, the tax liability can be staggering. As a result, companies that utilize tax deferred exchanges as part of their tax planning strategy can benefit from significant tax savings.

Personal property assets that are either "like-kind" or "like-class" are exchangeable. To be of "like-class," the relinquished and replacement depreciable tangible personal property must be in either the same General Asset Class or Product Class. For example, the exchange of a hotel may require a separate exchange for each different asset class: delivery trucks, restaurant equipment, furniture, and computer equipment.

The General Asset Classes are as follows:

- *Office furniture, fixtures and equipment;*
- *Data handling equipment, except computers;*
- *Information systems (computers, etc.);*
- *Airplanes (except commercial passenger or freight carriers) and all helicopters;*
- *Automobiles, including taxis;*
- *Buses;*
- *Light general purpose trucks;*
- *Heavy general purpose trucks;*
- *Railroad cars and locomotives;*
- *Tractor units;*
- *Trailers and trailer-mounted containers;*
- *Vessels, barges, tugs, except those used in marine construction;*
- *Industrial steam and electric generation and/or distribution systems*

The Product Classes are from Sectors 31 through 33 of the North American Industry Classification System (NAICS), which was adopted in 2002 but not utilized for tax deferred exchanges until August, 2004 under the new regulations adopted by the IRS. If the depreciable tangible personal property does not fall within either a General Asset Class or a Product Class the exchange can still be completed as long as the relinquished and replacement properties are considered to be of a "like-kind."

An exchange of intangible personal property and non-depreciable personal property qualifies for tax deferral only if the exchanged properties are of a "like-kind" since there are no like classes provided for these types of properties as in depreciable tangible personal property. The test as to whether intangible personal property is of a "like-kind" depends upon the "nature or character of the rights involved" and also on the "nature or character of the underlying property to which the intangible personal property relates". For example, a copyright on a novel can be exchanged for a copyright on another novel but a copyright on a novel cannot be exchanged for a copyright on a song because they are not considered "like-kind" property. The goodwill of one business, however, is not considered "like-kind" with the goodwill of another business and is, therefore, not eligible for exchange treatment.

Tax advisors are essential for a successful personal property exchange since, among other necessary elements, on the sale of a business they will help the Exchanger determine the respective property values and allocate sales price and purchase price to each element of the transaction. When disposing of personal property assets that are used in a business, such as airplanes that will be replaced with newer airplanes, an advisor can help structure the §1031 exchange to defer capital gains tax, and also address sales and use tax considerations.