BOTTOM LINE

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Defer Taxes, Maximize Value with a Like-Kind Exchange

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If owners are looking to maximize the resale value of a used car, they generally sell on the private market rather than trade in the car at a dealership. Imagine their satisfaction if it was possible to maximize the value while also deferring taxes.

Contractors that own heavy equipment can accomplish just that by taking advantage of a tax strategy called the like-kind exchange.

Under Section 1031 of the federal tax code, a property owner can swap one or more assets with those of "like kind" and defer the gain recognized from the transaction until the replacement property sells. Because the gain is deferred, the taxes due on that gain are deferred, allowing the property owner to use the money in a more productive way.

Like-kind exchanges have been popular in the real estate industry for years. However, a like-kind exchange of heavy equipment can reap even greater tax savings than a real estate exchange because income from equipment sales typically is considered ordinary income, which is taxed at the highest rate (currently 35 percent for most taxpayers). Real estate, on the other hand, is taxed at the capital gains rate (currently 15 percent for most taxpayers, but that rate is scheduled to increase to 20 percent in 2010).

After analyzing all options, land owners may decide they are better off paying the capital gains taxes now rather than deferring and possibly paying more in the future. For equipment, capital gains only apply if the piece of equipment sold for more than it was purchased—an unlikely scenario.

Like-kind exchanges free up more money to spend on new equipment. For example, a contractor purchased a piece of equipment for $100,000 that has depreciated to $40,000. If the contractor sold that piece of equipment for $80,000, it would have to pay ordinary income tax rates on most or all of the gain, leaving significantly less money to purchase another piece of equipment. In a like-kind exchange, the contractor would have the full $80,000 to apply to a new piece of equipment.

DEFERRED EXCHANGES

It isn't always easy to find someone with whom to make a straight exchange of equipment. A "deferred exchange" allows a contractor to sell equipment and still enjoy the benefits of a like-kind exchange. In a deferred exchange, a contractor sells equipment and the proceeds are collected by a qualified intermediary, which holds the money in a qualified exchange account until replacement equipment is identified. The intermediary then pays for the new equipment from the account.

Deferred exchanges are subject to complex rules. Contractors should consult a tax professional before participating in a transaction. Among other things, replacement equipment must be identified within 45 days of selling the old equipment, and the purchase must be completed within 180 days.

Another option is a "reverse deferred exchange," in which replacement equipment is purchased before the old equipment is sold. As with deferred exchanges, reverse exchanges are subject to complicated rules, restrictions and timetables, so professional guidance is recommended.

In general, contractors should consider taking advantage of like-kind exchanges if they buy and sell heavy equipment on a regular basis, or if they've identified a large piece of equipment they want to purchase and have similar equipment they'd like to move.

Keep the following in mind when considering how best to dispose of equipment.

- To qualify for a tax-free exchange under Section 1031, the equipment being swapped must be of like kind. The definition of like-kind for personal property is narrower than it is for real property. For construction equipment, it usually means the items being traded must come from the same general asset class or the same product class, so a contractor can't exchange a paver for a pickup truck. An equipment dealer or finance company can help identify like property.
- While like-kind exchanges can occur between private parties, special rules apply if the parties are related. The Internal Revenue Service wants to ensure that two subsidiaries of the same company aren't playing a shell game by swapping equipment.
- Consider the pros and cons of a like-kind exchange versus a trade-in or lease. As with a like-kind exchange, a trade-in also allows deferral of taxes, but the price for a trade-in generally is lower. Contractors should determine the price they can get in either scenario before making a decision. They also should consider whether leasing equipment is a better move. Generally, large equipment holds its value well, making it a good investment for contractors that use it regularly.
- Factor in the cost of a qualified intermediary, the legal costs of setting up an agreement, and the hassle involved in identifying like property and completing the deal in the required amount of time. Because of these financial and time investments, the strategy is only appropriate when significant gain is involved.
- Depreciation deductions in a straight sale may be greater than in a like-kind exchange. If a piece of equipment originally purchased for $100,000 has depreciated to $40,000 and is exchanged for another piece of equipment worth the same amount, the tax basis would remain $40,000 and depreciation would continue as if the exchange never occurred. However, if the equipment was sold for $80,000 and another piece of equipment was purchased for the same amount, ordinary taxes would be due on the $40,000 gain. But, the owner also would benefit from larger depreciation deductions. A construction-oriented accounting firm can help contractors determine which scenario is most beneficial.

Before engaging in a transaction, contractors should ask their CPA to calculate the gain from a sale of real estate or heavy equipment and determine how that gain will affect their tax basis.

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