Equipment exchanges for tax deferral

Like-kind exchanges are a cash flow management tool for almost any company that replaces depreciated equipment.

by BRUCE J. GOLDSTEIN

Like-kind tax-deferred exchanges, once considered of value only in the real estate industry, are now widely recognized as a cash flow management tool for almost any company that replaces depreciated equipment.

Potential benefits include a 40 percent cash flow benefit and a 4.5 percent present value cash savings.

Current year income

Equipment, though depreciated, also retains significant market value, and the sale results in current year taxable income (the recaptured depreciation credit) even if you sell it at a loss.

A "like-kind exchange," can defer those taxes for years and use the cash towards the purchase price of your replacement equipment.

The "like-kind tax-deferred exchange" provision of the Internal Revenue Code has been around since the 1920s. However it was only in the aftermath of a number of court cases in the 1980s that the IRS yielded and published regulations that made "like-kind exchanges" workable as a tax management tool for equipment owners.

Not a 'swap'

Contrary to common belief, like-kind exchanges do not require a property "swap." A like-kind exchange is a sale of used equipment followed by a purchase of replacement property, dressed up to meet a number of IRS requirements.

You do not have to buy your new equipment from the buyer of your old equipment, and the two can occur up to 180 days apart.

Tax-deferred, not tax-free

Your tax basis in your replacement equipment will be reduced dollar-for-dollar by the gain that was not recognized as income in the exchange. In other words, your basis in the replacement equipment will be limited to the new cash you contribute, which means that over the tax life of the replacement equipment, you will have smaller depreciation credits.

The net result: you pay the same taxes, but over the multi-year tax life of the new equipment rather than up front. This yields both a cash flow benefit and a present value savings due to the time value of money.

If you are exchanging fully depreciated equipment, the present value savings at an eight percent discount rate are approximately 4.5 percent of the sale price of your old equipment.

The "like-kind exchange" is generally considered a low-risk tax strategy. Talk with your tax advisor to determine if it's for you. The greatest risk is the security of your funds. The funds should be escrowed with a reliable institution and available for disbursement only with your signature. □

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How exchanges work

1) Before or after you agree to sell your old equipment, you enter into an agreement with a "qualified intermediary," an unrelated, third-party who facilitates the exchange. Under IRS regs, the intermediary can't be an associate, your attorney or your accountant. In those cases where you need to acquire the new equipment before you sell the old equipment, the same benefits can be achieved through a similar but more complicated mechanism known as a "reverse exchange."

2) You assign your rights under your sale agreement to the qualified intermediary. At your direction, the intermediary sells your old equipment to the buyer, who pays the proceeds into an escrow account established for the exchange.

3) Within 45 days following the sale of your old equipment, you must "identify" your like-kind replacement equipment.

The definition of "like-kind" can be broad, depending on the type of equipment being sold. "Asset classes" identified by the tax code include trailers, light trucks, heavy trucks, vessels, aircraft and computers.

4) After you enter the agreement for your "like-kind" replacement, you assign the contract to the qualified intermediary. At your direction, the qualified intermediary buys the replacement equipment on your behalf using the escrow funds together with any cash you contribute to meet the price of the replacement.

5) The title to the equipment and all contractual obligations such as the seller's warranties pass directly from the seller to you. The qualified intermediary only facilitates the transaction. Buying through a "like-kind exchange" will not interfere with the security of your interest in the equipment or your ability to make warranty claims.