

## ***Benefits of IRC §1031 for Business-Use Assets***

### ***About the FEA***

The Federation of Exchange Accommodators (“FEA”) is the industry association for professional exchange facilitators, also known as Qualified Intermediaries (“QI”). FEA member companies facilitate tax-deferred exchanges of investment and business use properties under IRC §1031 for taxpayers of all sizes, from individuals of modest means to high net worth taxpayers and from small businesses to large entities. Members represent a broad spectrum of the industry, ranging from small privately held businesses to large publicly traded companies and banks, located in small towns to large cities across the nation.

### ***Internal Revenue Code Section 1031***

Since 1921, §1031 has permitted a taxpayer to exchange business-use or investment assets for other like-kind business use or investment assets without recognizing taxable gain on the sale of the old assets. The taxes which otherwise would have been due from the sale are thus deferred. Section 1031 transactions range from relatively simple “trade-ins” or 2-party “swaps,” to more complex non-simultaneous §1031 exchanges involving separate buyers and sellers. Qualifying assets include commercial, agricultural and rental real estate, aircraft, trucks, trailers, containers, railcars, agricultural equipment, other heavy equipment, livestock and other assets involved in a broad spectrum of industries. Tax rules for non-simultaneous exchanges require the use of an independent third party Qualified Intermediary. The QI holds the sale proceeds for the benefit of the taxpayer during the exchange, disbursing funds for purchase of like-kind replacement property, and returning any unused funds to the taxpayer at the end of the exchange. Section 1031 exchanges must be completed within 180 days. Taxpayers recognize gain and pay tax on any unused funds or when they ultimately “cash out” of their property.

### ***Tax Reform Implications for Business-Use Personal Property Assets***

Owners and lessors of business-use personal property assets such as equipment and fleets utilize §1031 safe harbor guidelines set forth in Treasury Regulations and in Revenue Procedure 2003-39, to appropriately manage nonrecognition of gain and depreciation recapture when assets are replaced. This preserves cash flow and prevents a forced downsizing of the business. At a time when funding growth is limited to the ability to access cash, §1031 allows taxpayers to reinvest 100% of sales proceeds back into their businesses. This encourages companies to replace and upgrade assets, stimulating purchases and sales of machinery, equipment, railcars, aircraft, trucks, cars, mining and agricultural equipment sooner, because tax on the gain can be deferred. Section 1031 provides taxpayers with the opportunity to replace idle and under-utilized assets with the modern, energy efficient and environmentally friendly equipment required to stay profitable in competitive markets.

Tax reform aimed at reducing the deficit has renewed efforts to simplify the tax code and eliminate loopholes. **IRC §1031 is neither a loophole nor a tax savings vehicle, but rather a powerful economic engine based on sound tax policy that promotes growth and employment.** The non-recognition exchange policy is premised on the understanding that the taxpayer *continues with the same qualifying investment*, with no intervening receipt of cash, and is left in the same tax position as if the relinquished asset was never sold. This valuable section should not be eliminated or limited.

- **§1031 permits high volume owners of personal property assets, such as cars, trucks, tractors, trailers, heavy equipment, rail cars, mining and agricultural equipment, to**

**preserve cash flow and increase transactional volume.** Unlike real estate assets, which *appreciate* in value, gain on personal property business use assets is derived by calculating the difference between the fair market value of the used equipment and its remaining *depreciable* tax basis. Many of these productive assets are depreciated over a 3, 5 or 7 year tax life. The impact of bonus depreciation, intended to stimulate manufacturing and sales by allowing a first year depreciation deduction of 50% - 100% of the value of the asset, has left taxpayers with artificially low tax basis, and large built-in gains (notwithstanding that the fair market value of the used asset is less than its original purchase price). For example, an equipment leasing company that wishes to replace equipment purchased in 2010 already has a zero tax basis in that equipment, and without §1031 would lose 40% of the value of the sold asset to ordinary income taxes, resulting in reduced cash flow available for purchase of new equipment.

- **Elimination of §1031 would result in a direct tax on cash flow, not profits.** §1031 permits a continuity of investment by the taxpayer without reducing cash flow available for growth of the business. The value of assets exchanged remains invested in the taxpayer's business. **The taxpayer doing a §1031 exchange is not taking any profit from this transaction; it is being plowed back into the business. Without the current treatment under §1031, cash-strapped owners of business-use assets could be forced to downsize their businesses, farms, ranches, and operations** if they don't have sufficient *additional* cash flow to acquire replacement assets *and* pay tax on the gain from the sale of the old asset.
- **§1031 permits efficient use of productive capital and cash flow** while allowing taxpayers to shift to more productive like-kind property or otherwise transition to meet changes in business needs. Tax-deferred exchanges provide an important stimulus to a multitude of economic sectors, having local, national and global effect.
- **§1031 exchanges contribute significantly to the velocity of the economy and promote investment in the U.S.** Owners of personal property assets used predominantly in the United States may only obtain tax deferral benefits by reinvesting in like-kind domestic assets. An energy company, for example, cannot receive tax deferral benefits for selling mining, gas and oil field machinery in Texas and moving their production activity to Canada. §1031 provides a strong incentive to multinational companies to maintain and increase investments in the US.
- **§1031 provides only a temporary deferral; taxes are not eliminated.**
- **Gain deferred is directly offset by an equal reduction in future depreciation deductions for replacement assets acquired through an exchange.** The tax basis of newly acquired replacement property is reduced by the amount of the gain not recognized due to the exchange of the relinquished (sold) property. This results in increased annual taxable income over time, taxed at ordinary income tax rates.
- **Elimination of §1031 would result in a substantial increase in annual depreciation deductions, eroding potential revenue to be raised through elimination of tax deferral.**
- **Elimination of §1031 would have a chilling effect on business transactions.** Without the tax incentive, many transactions, including sales and purchases of machinery, equipment and leased assets will be delayed or abandoned.
- **Fewer transactions also translate into reduced capital investment and fewer jobs** in the manufacturing, equipment lease financing, vehicle and equipment rental, after-market alteration, customization and installation industries.

### ***Understanding Depreciation and Timing Benefits for Business-Use Asset Exchanges***

When a depreciated asset is exchanged under §1031, the taxable gain / depreciation recapture is not recognized, but rather is rolled into the new asset. Depreciation is only allowable for any remaining tax basis and for value representing **additional capital investment** into a like-kind asset. For example, a company vehicle has a fair market value of \$10,000, but it is fully depreciated. It has a tax basis of \$0 and depreciation recapture gain of \$10,000 at the time of sale. If it was exchanged for a replacement vehicle at a cost of \$10,000, that replacement vehicle would have the same tax characteristics and no further depreciation would be allowed. If the replacement vehicle cost \$25,000, then only \$15,000, representing the additional investment, would be available for additional depreciation over a new tax life. If the relinquished company vehicle was not fully depreciated, but had a remaining tax basis of \$2,000, and the new vehicle cost \$25,000, then the maximum depreciation allowed on the replacement vehicle would be \$17,000 (remaining tax basis plus additional investment).

The total depreciation expense allowed over the life of an asset which participates in an exchange or an ongoing exchange program is no greater than the depreciation expense of an asset that does not participate in an exchange or exchange program. Section 1031 benefits the taxpayer by permitting immediate reinvestment of the entire amount of sale proceeds back into the business, rather than impacting cash flow by forcing that taxpayer to recoup that capital investment slowly, over a multi-year depreciation schedule. Essentially, it provides a cash flow timing benefit.

The attached illustration demonstrates that over the tax life of a depreciable asset, the dollar impact of §1031 to the U.S. Treasury is zero.

### ***Summary***

Section 1031 provides significant benefits to taxpayers of all sizes with a “trickle down, spillover” economic stimulus effect on a myriad of industries and small businesses across the country. Economic policy efforts focus on encouraging investment in productive assets, encouraging additional borrowing by qualified investors, increasing the velocity of transactions, redeploying underutilized or idle assets, and discouraging fearful contraction and cash hoarding. Section 1031 encourages growth by mandating reinvestment in like-kind assets, increasing job growth and ordinary income generated by additional capital investment, discouraging the hoarding of capital and penalizing profit taking by taxing value taken out of the economy. ***Section 1031 not only encourages reinvestment over profit taking, it provides a strong incentive to keep that investment at home, in the United States.***

### **Illustration of Impact of §1031 on 5-Year Asset Sold v. Exchanged**

Assume that a heavy service truck that was placed into service in December, 2007 and has a current fair market value of \$25,000 is being exchanged for a new heavy truck in 2013 at a cost of \$100,000. (Illustration assumes a 35% corporate tax rate). Since the old truck has a zero tax basis, the non-recognized recapture gain of \$25,000 is transferred to the replacement truck, reducing the new truck's depreciable basis by \$25,000. Note that forgone depreciation over the 60 month depreciation schedule equals the \$25,000 gain deferred in the exchange. Section 1031 provides a timing benefit for tax payment, not a tax savings benefit. The benefit to the taxpayer is that current cash flow is preserved and available for reinvestment into the new truck. Cash flow is not eroded by an immediate tax liability of \$8,750, but rather the tax liability is paid incrementally, spread out over the depreciation schedule through reduced depreciation deductions.

<b><u>Relinquished Property</u></b>				
Original Cost	\$ 83,000			
Depreciation taken	<u>\$ (83,000)</u>			
Adjusted Tax Basis	\$ 0			
Selling Price	\$ 25,000			
Less: Adjusted Tax Basis	<u>\$ 0</u>			
<b>Tax Gain</b>	<b>\$ 25,000</b>			
Federal Tax Due in 2013 if Sold	\$ 8,750			
Federal Tax Due in 2013 if Exchanged	\$ 0			
<b><u>Replacement Property</u></b>	<b>Taxable Sale &amp; Purchase (No Exchange)</b>	<b>Exchange</b>	<b>Forgone Depreciation from Exchange</b>	<b>Additional Federal Income Tax Paid Attributed to Forgone Depreciation</b>
Cost of New Truck	\$ 100,000	\$ 100,000		
Deferred Gain	<u>\$ 0</u>	<u>\$ (25,000)</u>		
<b>Adjusted Basis of New Truck</b>	<b>\$ 100,000</b>	<b>\$ 75,000</b>		
Depreciation Year 1 (half year)	\$ 20,000	\$ 15,000	\$ (5,000)	\$ 1,750
Depreciation Year 2	\$ 32,000	\$ 24,000	\$ (8,000)	\$ 2,800
Depreciation Year 3	\$ 19,200	\$ 14,400	\$ (4,800)	\$ 1,680
Depreciation Year 4	\$ 11,520	\$ 8,640	\$ (2,880)	\$ 1,008
Depreciation Year 5	\$ 11,520	\$ 8,640	\$ (2,880)	\$ 1,008
Depreciation Year 6 (half year)	<u>\$ 5,760</u>	<u>\$ 4,320</u>	<u>\$ (1,440)</u>	<u>\$ 504</u>
<b>Total Allowable Depreciation</b>	<b>\$ 100,000</b>	<b>\$ 75,000</b>	<b>\$ (25,000)</b>	
<b>Total Federal Income Tax Paid Attributed to Forgone Depreciation</b>				<b>\$ 8,750</b>