

Personal Property Exchanges

Deferring capital gain and other taxes through an IRC §1031 tax deferred exchange is also available for personal property held for investment or for productive use in a trade or business. Despite its name, personal property does not necessarily mean property that is used by an individual in a personal capacity. Rather, 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 a §1031 exchange.

The gain realized from the sale of real property usually is comprised of two components, 1) appreciation of the asset beyond its original purchase price and 2) recapture of any depreciation allowed. Tangible personal property differs from real estate in that the gain realized on the sale of business-use personal property assets, such as machinery and equipment, typically comes only from recapture. Even though the used asset is worth considerably less than the original purchase price, the tax on the amount subject to recapture can be substantial. Many types of business-use assets can be fully depreciated in as little as 5 years, resulting in an asset with an adjusted basis of zero. Recapture on personal property is taxed at ordinary income tax rates, which are considerably higher than capital gain tax rates. Appreciation on collectibles held for investment is taxed at the maximum capital gain tax rate of 28% (unless the Exchanger is in the 15% income tax bracket). Thus, if the fair market value of the relinquished personal property asset is greater than its adjusted basis (cost of the asset minus depreciation allowed), a gain will be realized, and it makes good sense to consider a tax deferred exchange.

Consider the example of an automobile purchased for business use for \$38,000. The company sells the vehicle 3 years later for \$24,000. The company has taken depreciation deductions on its tax return over the 3 years totaling \$27,056 (pursuant to the 5 year MACRS depreciation schedule of IRC §168), leaving an adjusted basis of \$10,944. Even though the vehicle is sold for \$14,000 less than its original purchase price, the company will realize a gain on sale of \$13,056 (\$24,000 sale price less adjusted basis of \$10,944) due to depreciation recapture. Assuming a 35% corporate tax rate, the company would incur a tax liability of \$4,570 from this sale. For leasing companies and companies with large fleets of vehicles that dispose of and replace thousands of vehicles per year, the aggregate annual tax liability can be staggering. As a result, companies that utilize §1031 exchanges as part of their tax planning strategy can benefit from significant tax savings.

Although a §1031 exchange is created by federal statute, Exchangers may need to look to state law to determine if the property to be exchanged is real or personal. The following are examples of some of the myriad types of personal property that can be exchanged:

Broadcast Spectrums	Airplanes	Franchise Licenses	Coin Collections
Trailers and Containers	Trucks	Construction Equipment	Copyrights
Restaurant Equipment	Barges	Artwork	Office Furniture
Fleet of Automobiles	Helicopters	Agricultural Equipment	Buses

The “like-kind” requirement is more challenging for personal property exchanges than it is for real property exchanges. To qualify for exchange treatment, the relinquished and replacement assets must be either “like-kind” or “like-class.” “Like-kind” refers to assets that are the same, such as an airplane exchanged for an airplane, or a backhoe exchanged for a backhoe. “Like-class” refers to tangible, depreciable personal property that falls within the same General Asset Class or within the same Product Class, sharing the same 6-digit NAICS code. Treas. Reg. §1.1031(a)-2. The Product Classes are found in Sectors 31 through 33 of the North American Industry Classification System (NAICS).

Under the like-class definition, an airplane could be exchanged for a helicopter because they both fall within the same General Asset Class. Similarly, the backhoe could be replaced with a bulldozer, dredging machinery, a road grader or a log splitter, because all of these assets are included within the Construction Machinery Product Class identified by NAICS code 333120. However, the airplane could not be exchanged for a ship because they are neither “like-kind” nor “like-class” to each other. Interestingly, livestock of one sex is not like-kind to livestock of the opposite sex.

Brief Exchanges

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Personal Property Exchanges *(Continued)*

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, and tugs, except those used in marine construction;
- Industrial steam and electric generation and/or distribution systems

An exchange of intangible personal property (such as patents) and non-depreciable personal property (such as collectibles like artwork or precious musical instruments) qualifies for tax deferral only if the exchanged properties are “like-kind” to each other; the General Asset Classes and Product Classes do not apply. The test as to whether intangible personal property is “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.” Treas. Reg. §1.1031(a)-2(c). For example, a copyright on a novel can be exchanged for a copyright on another novel but not for a copyright on a song. It is important to note that goodwill, trademarks, and trade names of one business are also not like-kind to the goodwill, trademarks, or trade names of another business.

The IRS published valuable insight to the challenge of determining the like-kind standard for intangibles in PLR 200602034. The taxpayer was advised that “whenever possible, the underlying tangible personal properties to which the intangible asset relates should be compared using the same General Asset Classes and Product Classes already afforded for testing whether personal properties are of like-class.” In other words, while the nature and character of the rights of two patents are the same, a patent for a printing press would not be like-kind to a patent for a tractor because the underlying properties are neither like-kind nor like-class.

Tax advisors are essential for a successful personal property exchange as they will assist the Exchanger in the sometimes complicated process of determining whether the assets to be exchanged are like-kind or like-class, and in determining recapture and ultimate gain.

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