WHAT DO HOTELS, GAS STATIONS, BOATS & ARTWORK ALL HAVE IN COMMON?

Real Estate Exchanges are the “flagship” of the IRC §1031 practice, and certainly the more well known of the tax deferred exchange structures. However, a great many business investment transactions are solely personal property transfers or have a personal property component attached. Avoidance of depreciation recapture is often the reason for structuring a personal property exchange, and many do not realize that taxable gains on these properties can be deferred.

Advisors and investors should be aware that even though an asset’s value at sale may be less than its original price, such that there is no gain from appreciation, there may still be a taxable gain if the tax basis is less than the fair market value of the asset. This situation routinely occurs with depreciable business use assets. Ordinary income tax on the gain subject to personal property depreciation recapture can be substantial (upwards of 35%).

Has a cost segregation study been done on real estate being sold? This is a beneficial tool that permits greater depreciation deductions on real estate improvements. However, the presence of cost segregation should sound the alarm that a sale of that property will likely trigger a larger than usual amount of recapture. The good news is that recapture gain, just like capital gain, can be deferred with a §1031 Exchange!

Note that “personal property” does not refer to an individual’s belongings or personal use assets. It refers to non-real estate assets, which to qualify for §1031 treatment, must be held for productive use in a trade or business or for investment. Tangible property, such as car fleets, business equipment, charter boats, fishing vessels, planes, trucks, construction or agriculture equipment, artwork and collectibles, as well as intangible property, such as franchise licenses, cell towers, broadcast spectrums or copyrights, can all be the subject of a §1031 exchange. Keep in mind that the goodwill of one business is never like-kind to the goodwill of another business.

In a real estate exchange the like-kind test is fairly flexible. All real estate within the United States is like-kind to all other domestic real estate, so a taxpayer could exchange raw land for an apartment building or a commercial building. The concept of like-kind is much narrower for personal property assets. Tangible depreciable personal property assets may be either “like-kind” (sharing the same nature and character), such as front-loader for a front loader, or “like-class,” included within the same General Asset Class (described in Rev. Proc. 87-56) or Product Class (identified with the same NAICS Code), such as a front loader for a back hoe or other construction equipment. If the assets are not depreciable, such as artwork, then they must be like-kind to each other; the asset and product classes do not apply.

Intangible assets are like-kind if the “nature or character of rights involved” and the “nature or character of the underlying property to which the intangible personal property relates” are the same. For instance, a copyright on a novel is like-kind to a copyright on a novel but is not like-kind to a copyright on a song.

Due to the varied nature of businesses and personal property as a whole, thorough review of the property’s tax situation and its asset allocations in advance of a sale is prudent:

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