IPX 1031℠ Exchange Topics

Personal Property Exchanges

Deferral of 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. "Personal property" should not be confused with "personal use property" that refers to an asset used for the personal enjoyment of the taxpayer. Rather, "personal property" refers to all property, both tangible and intangible, that is not considered real property. When the sale of qualifying personal property will result in a gain, the taxpayer should 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 depreciation 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 artwork and other collectibles held for investment is taxed at the maximum capital gain tax rate of 28%. Thus, if the fair market value of the Relinquished Property 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.

Following are examples of some of the myriad types of personal property that can be exchanged:

Agricultural Equipment	Fleets of Autos or Trucks
Airplanes & Helicopters	Franchise Licenses
Artwork	Oil & Gas Field Production Equipment
Barges & Marine Vessels	Patents
Broadcast Spectrums	Precious Musical Instruments
Buses	Printing Presses
Coin Collections	Race Cars or Antique Cars
Construction Equipment	Race Horses
Distribution Routes	Railcars & Locomotives

The "like-kind" requirement is narrower for personal property than for real property exchanges. Although federal law controls, state law is relevant in determining whether the asset to be exchanged is real property or personal property. ILM 201238027. To qualify for exchange treatment, the Relinquished and Replacement Properties 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).

Personal Property Exchanges (CONT.)

The thirteen General Asset Classes are:

1. Office furniture, fixtures and equipment
2. Information systems (computers and peripheral equipment)
3. Data handling equipment, except computers
4. Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines)
5. Automobiles and taxis
6. Buses
7. Light general purpose trucks
8. Heavy general purpose trucks
9. Railroad cars and locomotives, except those owned by railroad transportation companies
10. Tractor units for use over-the-road
11. Trailers and trailer-mounted containers
12. Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction
13. Industrial steam and electric generation and / or distributions systems

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 other sex. IRC §1031(e).

An exchange of intangible personal property (such as patents, licenses, government permits and emissions credits) or 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." See 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. Goodwill of one business is not like-kind to the goodwill of another business, but trademarks, trade names and mastheads that can be valued separately from goodwill may be like-kind to trademarks, trade names and mastheads of another business. CCA 200911006.

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." Following that guidance, 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. Similarly, an exchange of intangible property used predominantly outside of the United States would not qualify as like-kind to intangible property to be used predominantly within the United States.

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.