



Accruit, LLC
1514 Curtis St.
Suite 300
Denver CO 80202
o: 303.865.7300
877.793.9215
f: 303.865.7399
www.Accruit.com

LKE 101: Increasing Cash Flow Through Section 1031 Like-Kind Exchanges

Overview: Making the Complex Simple

Traditionally 1031 Like-Kind Exchange (LKE) programs could be inefficient and cumbersome. In seeking new methods of increasing cash flow, many companies considered the tax deferral strategy available through Internal Revenue Code (IRC) Section 1031, weighing the potential benefit against the associated costs of performing LKEs. Some companies have concluded that they lack the sales volume necessary to justify an LKE program. The labor involved in administering LKEs through a paper-based process was simply not deemed economical except for those businesses with extraordinarily large-ticket items (such as airplanes, ships and railroad equipment).

Today, however, this has all changed. An effectively managed, technology-based LKE program allows businesses of all sizes to realize significant rewards from a 1031 LKE program.

Like-Kind Exchange Defined

IRC Section 1031 allows companies to sell an asset and defer realization of any gain (and therefore the associated tax) when the proceeds of the sale are used to purchase an asset of similar type. There are three fundamental rules that must be observed for a transaction to qualify as a Like-Kind Exchange:

1. Assets must be structured as an exchange.
2. Exchanged assets must be of similar classification.
3. Exchanged assets must be used in a trade or business.

While these guidelines outline the general requirements of defining a transaction as an LKE, there are several additional regulations that strictly moderate the process.

The Role of the Qualified Intermediary

The single most important step an LKE participant must take is the inclusion of a Qualified Intermediary (QI) in the

sales and purchasing process. As stipulated by Section 1031, to qualify as an LKE all proceeds from an asset sale must be deposited with a recognized QI until such time as a replacement asset is acquired. The owner of an asset:

- a. assigns the rights (but not any associated obligations) to sell the asset to the QI,
- b. the QI is paid directly by the purchaser of the asset, and sales proceeds are directed to the QI; and,
- c. the QI uses these proceeds to purchase a replacement asset on behalf of the original owner.

The proper facilitation of exchanges by these third-party providers ensures that businesses leveraging LKEs - whether they're conducting single exchanges or employing a full-fledged program - are not considered to be in active or constructive receipt of funds; this is critical to establishing a qualified exchange. Typically, repetitive LKE relationships with a QI are governed by a Master Exchange Agreement, wherein participants assign future purchase and sale rights to their QI, thus reducing the burden normally associated with individual transactions.

"The best part of working with Accruit's Like-Kind Exchange program is the support and guidance from their customer service representatives. They make a complex issue seem so easy!! It was a pleasure working with Accruit and we will utilize their services again in the future."

- Controller, Sanford Contractors, Inc.

Case Study: Silver State Equipment

Silver State Equipment* (SSE) has, as its primary lines of business, the rental and sale of heavy equipment. With several local branches across Nevada, SSE has been especially successful renting equipment to both commercial and residential builders. Given the high usage rates associated with their rented equipment, they typically upgrade their equipment every three years.

Scenario 1: LKE vs. No LKE. In the absence of an LKE program, SSE would realize a tax burden of \$18,824 on the sale, leaving only \$65,676 to apply toward the purchase of a replacement dozer.**

With an approved LKE program, however, the company maintains all proceeds from the original sale to roll forward into the purchase of a replacement asset.

	Before LKE	With LKE
Original Equipment Cost	\$130,000	\$130,000
Tax Depreciation Allowed	\$92,560	\$92,560
Tax Basis at Sale	\$37,440	\$37,440
Sale Price of Equipment	\$84,500	\$84,500
Taxable Gain on Sale	\$47,060	\$47,060
Tax Due on Gain (40% Tax Rate)	\$18,824	\$0
Cash Available for Replacement Equipment	\$65,676	\$84,500

Scenario 2: LKE vs. Bonus Depreciation: Using the same example and assuming that SSE had taken 50% Bonus Depreciation during the first year, we see the impact of the “Bonus Hangover” effect. In the absence of an LKE program, the company has only \$58,188 to invest in a replacement asset; however, with an Accruit LKE program in place, SSE has significantly more cash flow to apply to the sale of a new dozer.

	Before LKE	With LKE
Original Equipment Cost	\$130,000	\$130,000
Tax Depreciation Allowed	\$111,280	\$111,280
Tax Basis at Sale	\$18,720	\$18,720
Sale Price of Equipment	\$84,500	\$84,500
Taxable Gain on Sale	\$65,780	\$65,780
Tax Due on Gain (40% Tax Rate)	\$26,312	\$0
Cash Available for Replacement Equipment	\$58,188	\$84,500

For companies like Silver State, Accruit LKE solutions represent powerful return on investment propositions. Over the course of a year, Silver State conducts multiple single exchange transactions. When we weigh their recognized LKE deferral benefit and their accrued interest against their total annual program fees, **their ROI is a staggering 25,000%**. It’s important to remember that these funds are deferred instead of permanently captured, but if the LKE program is continued, the deferral is *potentially indefinite*.

* Modeled on an actual Accruit client case.

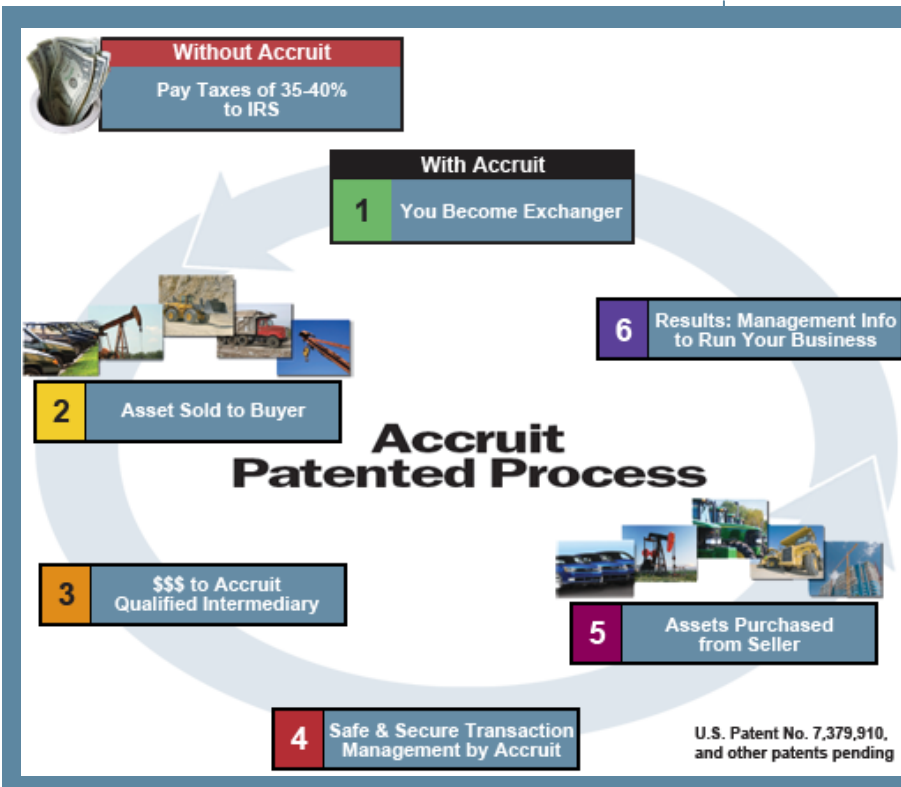
** Assumes 5-year MACRS depreciation on asset held for three years without bonus depreciation applied during the first year.

Classification of Like-Kind

Regulations governing the exchange process (TD 9151 and REG-116265-04, 8/12/04) stipulate the requirements for what is considered “like-kind.” The assets may, if eligible, first be classified by a General Asset Class (GAC) (defined by classes 00.11 through 00.28) as outlined in Revenue Procedure 87-56. The traditional practice of matching by Standard Industrial Classification (SIC) code was replaced in 2004 by guidelines requiring that all exchanged assets be of the same North American Industry Classification System (NAICS) Product Class. The NAICS system is a “production-oriented” method, meaning that the new system streamlines the identification process considerably. Additionally, this tightening of the regulations was an important step forward, as the SIC system had not been updated since 1987.

Critical Timelines

Specific timelines must be actively managed throughout the LKE process. The clock starts on the date of the original asset sale and has two critical milestones; the 45-Day Asset Identification Requirement and the 180-Day Acquisition Requirement. Section 1031 gives a participant in an LKE program 45 days from the original sale date to either acquire like-kind replacement property or identify the intended replacement property. In the case of identifying replacement property, the participant has three choices; the two most common are to either identify three potential replacements from which the selection will be made (the Three-Property Rule) or identify replacement property of a value not to exceed 200% of the original sales proceeds (the 200% Rule). In either case, some of this identified replacement property must be acquired within 180 days in order for the program to qualify for a Like-Kind Exchange.



In researching LKE service providers, it's important to consider three elements of a successful program:

- a. Qualified Intermediary,
- b. Cash Management, and
- c. LKE Transaction Administration (including asset-level tracking, depreciation calculation and reporting).

Winning providers will seamlessly integrate these components to ensure the participating business can maximize its benefit while minimizing administrative burden. Additionally, with an end-to-end solution, the participating business can continue to leverage its existing tax advisor to guarantee that its LKE program is in line with defined strategic goals and current tax paradigm.

Step-in-the-Shoes Depreciation

One of the most time-consuming procedures involved in an effective LKE program has been tracking of depreciation schedules as they relate to disposed and purchased assets, a task that was traditionally performed manually. When one depreciated asset is exchanged for another asset, the depreciation schedule of the disposed asset effectively continues even though the original owner no longer owns the asset.

Additionally, the newly purchased asset begins its own depreciation schedule. The amount to be depreciated on the new asset is the difference in value between the sold asset and the new asset (ie the "new cash" added to the exchange process to acquire replacement property).

Through this "Step-in-the-Shoes" method of depreciating a new asset, participants in an LKE program are allowed, if they choose, to continue to reap the benefits of depreciating assets without invalidating the LKE program and continuing to accelerate depreciation of the original asset. The challenging component of this process is that future layers of depreciation will grow exponentially as each successive generation continues participating in the ongoing LKE program.

Again, effectively managed, technology-based services are capable of tracking these numerous depreciation schedules at the asset level without necessitating a significant increase in headcount by the LKE participant.

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1031 Exchange Process Regulations

An effective Like-Kind Exchange program requires businesses to adhere to a series of very specific regulations, and this is where the historical expense of managing an LKE program became prohibitive.

In large-ticket industries, these functions were once performed by an accounting staff; however, the technology-based services available today have made LKEs viable for a far broader range of asset-owning businesses. These specific process regulations are an important point of differentiation between an LKE and a traditional asset sale and repurchase program.

"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment."

- Internal Revenue Code Section 1031, P. (a)(1)



Accruit

The Total 1031 Like-Kind Exchange Solution