Temporary or Permanent Economic Stimulation?

- 2008 Economic Stimulation Act vs. the Revenue Act of 1921

With the current housing slump and subprime lending issues leading to weakness in the construction industry, chances are you have studied the benefits of the 2008 Economic Stimulus Act for your business. What is the impact of Bonus Depreciation? Can you take advantage of increased Section 179 expensing?

These are good questions, but have you reviewed the permanent tax strategies that already exist in the code? Have you given them as much attention as the temporary initiatives just enacted? Are you aware of the provisions introduced in 1921 that offer you long-term tax deferral of up to 40% of the value of all the equipment you sell?

Congress added non-recognition of gain to our tax regulations as part of The Revenue Act of 1921, creating the foundation of Like-Kind Exchanges (LKEs). Maturing into Internal Revenue Code (IRC) Section 1031, these exchanges remove the tax penalty of selling depreciated (or appreciated) business assets and real estate. For real estate, 1031 Exchanges are used to defer capital gains taxes otherwise recognized when selling one property and buying another. The same concept applies for construction equipment and other personal property assets; however, the gain deferred is based on tax depreciation (the difference between an asset's depreciated value and its sales value). With the short tax depreciation cycle and long useful lives of heavy equipment, the gains are significant and taxed as ordinary income -- up to 40%

How It Works

Consider the sale of a fully depreciated $100 asset. Without LKE, roughly $40 is paid in income taxes, leaving only $60 for the purchase of replacement assets. With LKEs, however, the full $100 is applied to another asset. Assuming the second generation is purchased for $200, you begin a new depreciation schedule on the $100 of new funds invested and carry the tax deferral forward.

So long as you continue to sell and purchase assets considered "like kind," this tax deferral continues indefinitely. At the point where you begin to sell assets outside of LKEs, income taxes will be paid on the gain recognized at that point. From the example above, assume that the second generation asset is sold for $100 ten years after its purchase. The taxes due will mirror your income tax rate, or roughly $40. In the meantime, you have had $40 extra cash working in your business for ten years without making a single interest payment. Of course, this is a simple example. Imagine the impact if you sell $100,000, $1,000,000 or $10,000,000 in depreciated equipment each year.

Playing by the Rules

As with any tax regulation, to see the benefit you must play by the rules. In Internal Revenue terms, each guideline is called a "Safe Harbor" provision. Under Safe Harbor directives, there are a few critical components and several smaller hoops to jump through. The main requirements to complete a 1031 exchange are:

1. Assets exchanged must be held for business use or investment
2. A Qualified Intermediary must hold sales proceeds until replacement assets are purchased
3. The exchange must occur within a strict timeline
4. Exchanged assets must be the same classification
5. The exchange must be established in advance

Like-Kind Exchanges cannot be performed on any assets held in inventory, just those that are used in your business. In the heavy equipment industry, there are two primary users of Like-Kind Exchange: construction companies with equipment used on the job and equipment dealers with rental fleets and maintenance vehicles.

The second important regulation is the inclusion of a Qualified Intermediary for redirecting sales proceeds to replacement assets. This third party must not be someone related to your business or your agent including tax advisors or attorneys. In LKEs, as soon as you receive sales proceeds, you trigger the tax burden. The Qualified Intermediary ensures that these funds are not actively or constructively received, but rather applied to a purchase.

Third, the IRC details a specific timeline of an exchange. If replacement assets are not purchased within the first 45 days following the sale date, you must identify potential purchases to occur within an additional 135 days. Given these requirements, the entire lifespan of an exchange is the earlier of 180 days or the date of your tax filing.

What is "like kind"? The regulations specify that exchanged assets must be like kind or like class. For heavy equipment assets, many types of equipment fall in the same classification, allowing for broad exchange possibilities. Additionally, equipment exchanges offer significant flexibility because assets need not be of like quality, grade or age, and the proceeds from several sales may be applied to one purchase or vice-versa. Leveraging this flexibility allows you to adjust your fleet to market demands or project requirements without tax penalty.

To ensure your exchange meets Safe Harbor regulations, you must plan ahead and establish your transaction with a Qualified Intermediary prior to the sale of old assets or purchase of replacement property, although this is a very simple process. Establishing an account with Accruit, for example, takes roughly 30 minutes and is managed through a secure, online service.

Forward or Reverse?

Like-Kind Exchanges take several forms: Simultaneous exchanges, where both assets are transferred concurrently between two businesses; forward exchanges, where old assets are sold prior to purchasing replacement assets; and reverse exchanges, where replacement assets are purchased first and old assets are sold up to 180 days later. Of all transactions, reverse exchanges offer the best opportunity to keep equipment working as long as possible or to "double up" your fleet to meet short-term equipment demands.

Temporary or Permanent?

To combat the cyclical nature of our economy, the current administration enacted the Economic Stimulus Act of 2008, pushing money into the population and providing some temporary tax breaks for corporate America. As the excitement of the new stimulus package subsides, however, the benefit of The Revenue Act of 1921 persists. This little gem in our tax code can increase your cash flow immediately and indefinitely, making your business increasingly competitive no matter the economic climate. You just have to dig a little deeper to find it.
For More Information

Contact Accruit at 866.397.1031 or via email at info@accruit.com.

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