



TEMPORARY OR PERMANENT ECONOMIC STIMULATION?

2008 Economic Stimulation Act vs. The Revenue Act of 1921

By Jim Burnett

With the current housing slump and subprime lending issues leading to weakness in the construction industry, chances are most contractors have studied the benefits of the 2008 Economic Stimulus Act for their businesses. What is the impact of bonus depreciation? Can contractors take advantage of increased Section 179 expensing?

These are good questions, but have these same contractors reviewed the permanent tax strategies that already exist in the code? Have they given them as much attention as the temporary initiatives just enacted?

Are they aware of the provisions introduced in 1921 that offer long-term tax deferral of up to 40 percent of the value of all the equipment they sell?

Congress added non-recognition of gain to U.S. 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 percent.

HOW IT WORKS

Structurally, LKEs apply the sales proceeds of one generation of assets to the purchase of a subsequent generation of assets. As these funds are reallocated, the tax basis of the earlier generation passes into the second generation. Rather than paying depreciation recapture (income taxes on recognized gain) to the government and taking it back as depreciation in coming

years, all the cash is working in the business immediately as an interest-free loan from the federal government.

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 a contractor continues to sell and purchase assets considered “like kind,”

this tax deferral continues indefinitely. At the point where an owner begins 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 the owner's income tax rate, or roughly \$40. In the meantime, the owner has had \$40 in extra cash working in the business for 10 years without making a single interest payment. Of course, this is a simple example. Imagine the impact if the owner sells \$100,000, \$1 million, or \$10 million in depreciated equipment each year.

PLAYING BY THE RULES

As with any tax regulation, to see the benefit an owner 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 include the following:

- Assets exchanged must be held for business use or investment.
- A qualified intermediary must hold sales proceeds until replacement assets are purchased.
- The exchange must occur within a strict timeline.
- Exchanged assets must be the same classification.



ABOUT the AUTHOR



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- The exchange must be established in advance.

LKEs cannot be performed on any asset held in inventory, but can only be applied on those that are used in the business.

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 the business or the contractor's agent, including tax advisers or attorneys. In LKEs, as soon as an owner receives sales proceeds, the tax burden is triggered. 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, the owner must identify potential purchases to occur within an additional 135 days. Given these requirements, the entire life span of an exchange is the earlier of 180 days or the date of the 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 the contractor to adjust the fleet to market demands or project requirements without tax penalty.

To ensure that an exchange meets Safe Harbor regulations,

an owner must plan ahead and establish the transaction with a qualified intermediary prior to the sale of old assets or the 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?

LKEs take several forms, including the following:

- Simultaneous exchanges, where both assets are transferred concurrently between two businesses
- Forward exchanges, where old assets are sold prior to purchasing replacement assets
- Reverse exchanges, where replacement assets are purchased first and old assets are sold up to 180 days later

TEMPORARY OR PERMANENT?

To combat the cyclical nature of the U.S. 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 a contractor's cash flow immediately and indefinitely, making a business increasingly competitive no matter the economic climate. Owners just have to dig a little deeper to find it. ♦



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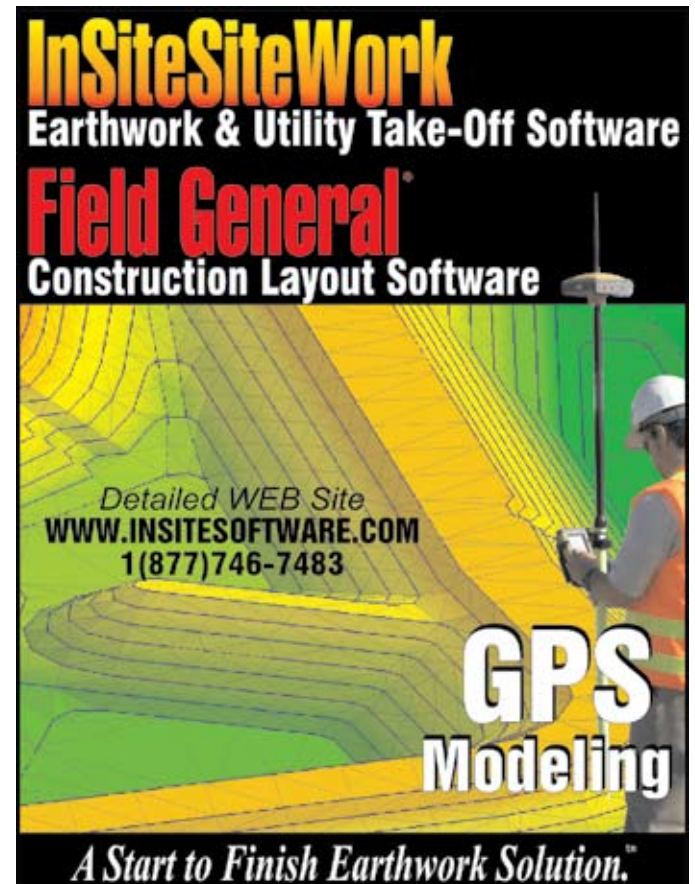
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