Personal Property Exchanges

Deferring 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. Despite its name, personal property does not necessarily mean property that is used by an individual in a personal capacity. Rather, personal property refers to all property, both tangible and intangible, that is not considered real property. If the sale of such personal property will result in a gain, the taxpayer may want to consider an exchange.

Generally speaking, both tangible depreciable personal property, such as cars, trucks and planes and intangible personal property, such as franchise rights, copyrights or broadcast spectrums, are acquired for a certain value known as a tax or cost basis. For example, if a truck is purchased for $10,000 cash and $30,000 in a loan, the tax basis for the truck is $40,000. The tax basis can decline over time because of use, wear, or obsolescence. This concept, known as depreciation, can affect the tax basis of property at different rates depending on the type of property and when it was acquired. For example, an automobile is currently considered a five year property under the Modified Accelerated Cost Recovery System (MACRS) of IRC §168, meaning that five years after its acquisition its tax basis will be zero.

Although an asset starts out with a tax basis, it is the amount that is known as the adjusted basis, which will determine the taxable gain, if any, upon the sale of the asset. An asset's adjusted basis is determined by subtracting the amount of depreciation taken, if any, from its tax basis and adding capital improvements made to the asset, if any. For example, an airplane is acquired for $120,000, which is its tax basis. Over a period of time it is depreciated in the amount of $36,000 to account for normal wear and tear, but it has had a capital improvement in the form of an avionics upgrade in the amount of $20,000. Therefore, the tax basis of $120,000, minus the depreciation of $36,000, plus the capital improvement of $20,000 results in an adjusted basis of $104,000.

In order to calculate if there is a capital gain tax liability from the sale of an asset, you must subtract the adjusted basis from the net sale price of the property. If the resulting amount is positive, there is a gain, and in most cases, a determination must be made as to what portion of the gain is due to the depreciation of the asset, and what portion of the gain is due to the appreciation (rise in market value) of the asset, as they may be taxed at different rates. For example an automobile is purchased for use by a business for $38,000, and is sold for $24,000 after three years. Although its cost basis was $38,000, it has been depreciated in the amount of $28,500, leaving an adjusted basis of $9,500. Accordingly, since the automobile is selling for $14,500 more than its adjusted basis, there is a tax liability. Assuming a 35% tax rate for depreciation recapture, the taxpayer in this example would owe approximately $5,075. For leasing companies and companies with large privately held fleets that dispose of and acquire thousands of vehicles per year, the tax liability can be staggering. As a result, companies that utilize tax deferred exchanges as part of their tax planning strategy can benefit from significant tax savings.

Although a tax deferred exchange is created by Federal statute, Exchangers must look to state law to determine if the property to be exchanged is real or personal. The following are examples of types of personal property that can be exchanged:

Broadcast Spectrums	Airplanes	Franchise Licenses	Coin Collections
Trailers and Containers	Trucks	Construction Equipment	Copyrights
Restaurant Equipment	Barges	Artwork	Office Furniture
Fleet of Automobiles	Helicopters	Agricultural Equipment	Buses

Personal Property Exchanges *(Continued)*

The "like-kind" requirement is more challenging for personal property exchanges than it is for real property exchanges. An asset may be either "like-kind" or "like-class". To be of "like-class," the relinquished and replacement depreciable tangible personal property must be in either the same **General Asset Class** or **Product Class**. For example, the exchange of a hotel may require a separate exchange for each different asset class: delivery trucks, restaurant equipment, furniture, and computer equipment.

The General Asset Classes are as follows:

- Office furniture, fixtures and equipment;
- Data handling equipment, except computers;
- Information systems (computers, etc.);
- Airplanes (except commercial passenger or freight carriers) and all helicopters;
- Automobiles, including taxis;
- Buses;
- Light general purpose trucks;
- Heavy general purpose trucks;
- Railroad cars and locomotives;
- Tractor units;
- Trailers and trailer-mounted containers;
- Vessels, barges, tugs, except those used in marine construction;
- Industrial steam and electric generation and/or distribution systems

The **Product Classes** are from Sectors 31 through 33 of the North American Industry Classification System (NAICS), which was adopted in 2002 but not utilized for tax deferred exchanges until August, 2004 under the new regulations adopted by the IRS. If the depreciable tangible personal property does not fall within either a General Asset Class or a Product Class the exchange can still be completed as long as the relinquished and replacement properties are considered to be of a "like-kind."

An exchange of intangible personal property and non-depreciable personal property qualifies for tax deferral only if the exchanged properties are of a "like-kind" since there are no like classes provided for these types of properties as in depreciable tangible personal property. The test as to whether intangible personal property is of a "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". For example, a copyright on a novel can be exchanged for a copyright on another novel but a copyright on a novel cannot be exchanged for a copyright on a song because they are not considered "like-kind" property. The goodwill of one business, however, is not considered "like-kind" with the goodwill of another business and is, therefore, not eligible for exchange treatment. Also, livestock of different sexes is not considered "like-kind" property.

Tax advisors are essential for a successful personal property exchange since, among other necessary elements, they will help the Exchanger determine the respective property values and allocate sales price and purchase price to each element of the transaction.